

Second  
Edition

**Wiley**  
**Federal  
Government  
Auditing**

**Laws, Regulations,  
Standards, and Practices**

Edward F. Kearney  
Roldan Fernandez

Jeffrey W. Green  
David M. Zavada

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**Laws, Regulations, Standards,  
Practices, & Sarbanes-Oxley**

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# PREFACE

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The last 35 years have significantly impacted Federal financial management, accounting and auditing. During this period significant changes were initiated within the Federal arena, including such seminal developments as the Federal Managers' Financial Integrity Act of 1982 relating to internal control, Chief Financial Officers Act of 1990 requiring audited financial statements, Federal Financial Management Improvement Act of 1996 providing statutory backing for basic financial and systems requirements, Federal Information Security Management Act of 2002 addressing IT security and major revisions in 2004 to the Office of Management and Budget's (OMB's) Circular A-123, *Management's Responsibility for Internal Control* requiring separate management assertions for internal control over financial reporting. However, the numerous changes occurring within Federal guidance should not detract from the importance of other developments affecting financial management throughout every industry. In 1992 the Committee of Sponsoring Organizations (COSO) issued its *Internal Control—Integrated Framework*, and in response to major financial scandals in the private sector Congress issued the Sarbanes-Oxley Act in 2002 (which in turn greatly influenced the issuance of the major revisions to Circular A-123 mentioned earlier).

The above requirements provide a statutory foundation for instilling sound financial management, internal control, and accounting discipline across the Federal Government. As Federal Departments and Agencies have progressed down the path of full compliance with these foundational requirements, other financial management laws have been enacted to address specific areas or concerns. In 2003, the Improper Payment Information Act (IPIA) was enacted and subsequently amended, to monitor and reduce improper payments estimated to exceed \$100 Billion government-wide, and in 2006, enabled by advances in technology, the Federal Funding Accountability and Transparency Act required detailed reporting of Federal spending information on a Government website. Spanning all of these requirements is the quest for timely and reliable information that is useful in improving the effectiveness and efficiency of Federal programs and operations. Federal financial management today entails multi-faceted challenges, but also opportunities – opportunities to provide the information to guide decision-making and financial accountability as we move forward as a nation to address our long-term fiscal challenges.

While Federal financial management continues to be the subject of Congressional and oversight agency scrutiny, and while the Federal Accounting Standards Advisory Board (FASAB) has continued to issue significant requirements affecting Federal accounting principles, the emphasis in the past ten years has been more on compliance with the requirements passed earlier and achieving the ultimate auditing goal: A “clean” audit opinion on the Consolidated Financial Statements of the Federal Government.

Uncharacteristically, in recent years, the more significant impact on Federal auditing and internal control guidance may have come from non-Federal sources — particularly the American Institute of Certified Public Accountants (AICPA). Of primary importance were the issuance of several risk assessment standards as well as additional Statements on Standards for Attestation Engagements (SSAEs). In addition, the Clarity Project, an ongoing effort scheduled to be completed in 2014 and designed to aid the understanding of generally accepted auditing standards, (GAAS) will likely have an impact on Federal auditing and bears watching. However, it is presently too early to assess the impact. Interestingly, while the AICPA pronouncements of the past ten years have had an impact on Federal financial auditing, the major outcome of these efforts has been to bring commercial auditing practices closer to the practices that had already been followed in Federal auditing and included in the Government Accountability Office's (GAO's) *Government Auditing Standards* (Yellow Book).

*Wiley Federal Government Auditing: Laws, Regulations, Standards, Practices, & Sarbanes-Oxley, Second Edition*, is directed to all auditors of Federal agencies and programs and all those who may be subject to audits by the Federal Government. The book provides essential knowledge for all who audit the Federal Government, its programs, contractors and grantees, including many who are affected by or should have some knowledge of the impact of a Federal audit.

Federal audit criteria is governed by a “patchwork” of laws enacted by many Congresses; regulations and rules issued by the OMB; rules and procedures required by the Council of the Inspectors General on Integrity and Efficiency (CIGIE); the government audit standards of the GAO (updated and revised several times since issuance in 1972); and where applicable or appropriate or mandated, various aspects or portions of the GAAS of the AICPA.

Federal auditing is not typically a course in a college curriculum; coverage of the subject is largely absent in writings and publications from academe. Federal law and regulations highlight the government's needs, objectives, and requirements, but detailed guidance on what, why, how, and by whom should Federal audits be made is sparse.

This book, *Wiley Federal Government Auditing: Laws, Regulations, Standards, Practices, & Sarbanes-Oxley, Second Edition*, by Kearney & Company, P.C., is intended as a single-source informative guide through the “patchwork” of criteria for performing audits unique to Federal departments and agencies, as well as Federal audits made of contractors and grantees, universities and other non-profits. Kearney & Company is a regional CPA firm founded in 1985 that specializes in providing auditing, accounting, and financial management services to the Federal Government's executive, legislative, regulatory departments and agencies and other organizations doing business with the Federal Government. Additional details on Kearney & Company can be found on our Web site at [www.kearneyco.com](http://www.kearneyco.com).

The book has been written in a manner to assist professionals and nonprofessionals, employed by the Federal Government or other organizations — government auditors

performing internal and external audits, Inspectors General, public accountants, military comptrollers, legislators, staff of legislators, state and local government auditors, financial managers, budget officers, program and financial analysts, attorneys, systems designers, and systems experts—in short anyone having an interest in or repeated financial dealings with the Federal Government. The book is divided into several parts in an attempt to better address interests of this diverse constituency; Some parts have more, some less, detail, for example:

*Part I—Background of Federal Auditing* consists of three chapters that highlight the evolution of Federal accounting and auditing; the laws, regulations, rules, standards and other requirements that form the criteria for audits of Federal departments and agencies; and of the myriad of organizations that do business with the Federal Government, principally through federally funded contracts and grants.

*Part II—Federal Financial Statements, Budgeting and Accounting* includes two chapters, addressing the budgeting, accounting, and financial reporting of the receipts, expenditures, and application of Federal monies, and Federal financial statements which are typically covered by the auditor's report.

*Part III—Auditing in the Federal Government* has several chapters that describe the scope and work performed to audit Federal departments and agencies. The initial chapter addresses a number of changes to audit guidance that took place over the past seven years including a discussion of the “risk assessment” standards issued by the AICPA in 2006. The remaining chapters provide an overview of significant audit activities including: planning the financial audit; auditing financial controls and compliance with laws and regulations; auditing selected Federal accounting transactions and accounts; concluding the audit and addressing end-of-audit concerns; and reporting on the result of an audit, including the form of required reporting and types of audit opinions.

*Part IV—Nature of Selected Federal Audits* highlights audit objectives, issues, tasks and concerns of other types of Federal audits and examinations. These audits and examinations are more limited in scope and include federally-mandated IT systems audits, contract audits, grant audits, and performance audits, as well as attestation reports. The specialized or expert knowledge required to plan, design and execute a methodology for selected specialized reviews appears in this part.

This book is the result of numerous consultations over many years with accountants, auditors, financial managers and systems consultants specializing in the financial management issues of the Federal Government. Additionally, reliance has necessarily been placed on the bodies of knowledge created by, among others, Congresses, the OMB, GAO, AICPA, FASAB, the Chief Financial Officers Council, and Offices of Inspectors General. Promulgations of all of these organizations have contributed to the body of knowledge one must possess to conduct an audit of any organization responsible for and dispensing Federal monies.



# **PART I**

## **BACKGROUND OF FEDERAL AUDITING**



# 1 BACKGROUND OF FEDERAL AUDITING

## ***Evolution, Standard Setters, Responsibilities, Audit Types***

The Federal Government's spending for fiscal year (FY) 2011 was almost \$3.8 trillion. The accumulated national debt (debt held by the public) was more than \$10.2 trillion. Annual Federal outlays accounted for roughly 25 percent of the country's gross domestic product (GDP) and debt held by the public is on an upward trend, now almost 70 percent of GDP. The Federal Government's financial statements presented on an accrual basis reported gross cost of almost \$4 trillion and total liabilities in excess of \$17.5 trillion for and as of the end of FY 2011, respectively. Never before has there been a greater time for accountability, credibility, and reliability of financial information to inform discussion and decision making.<sup>1</sup>

The numbers just cited are dramatic and emphasize the massive size, influence, and commitments of the Federal Government. They are also indicative of a growing need to accurately and consistently account for the Federal Government's financial activities. With so much at stake, accurately measuring and reporting the financial position and condition of the Federal Government has never been so important. The need for timely and reliable financial information to support budget and program management decisions is essential. The credibility of generally accepted accounting principles (GAAP) and audited financial statements is vital to government integrity, credibility, and maintaining confidence.

The Federal Government's response to the U.S. financial crisis that began in 2008 demonstrated the magnitude of the government's commitments and the underlying role the government plays in maintaining economic stability. From 2008 to 2010, the Federal Government assumed hundreds of billions of dollars in contingent liabilities to support government-sponsored enterprises, banking, financial services, and other industries to backstop financial markets and avoid further financial calamity.<sup>2</sup>

This chapter is being written at a time when the U.S. economy is still attempting to recover from the effects of that crisis and there is heightened awareness and interest in the financial condition and position of the U.S. government. Public debate and discussion of the long-term fiscal sustainability of spending and revenues at their current rates is

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<sup>1</sup> *Federal Budget for FY 2012, Historical Tables*, Office of Management and Budget, and *Financial Report of the U.S. Government for 2011*, U.S. Department of the Treasury.

<sup>2</sup> *Financial Report of the U.S. Government 2010*, U.S. Department of the Treasury.

increasing, and the President and Congress are engaged in budget discussions. External factors, such as the downgrading of U.S. debt ratings, highlight the need for credible financial management plans and transparent and reliable financial statements.

The Federal budget process is the primary management and accountability process in the Federal Government today. Budget formulation involves identifying policy and budget priorities along with funding justifications. Once enacted, budget execution tracks revenue and spending, primarily on a cash basis. The nature of the budget process subjects it to anecdotal analysis and political agendas, the pace of which has accelerated in the era of instantaneous communication and social media.

Federal accounting is intended to provide another perspective, a perspective that includes actual budgetary and accrual-based financial results, financial position, and condition. For some programs, such as social insurance programs like Medicare and Social Security, it also includes a view of longer-term fiscal sustainability. This view is supported by the credibility and integrity associated with transparent GAAP, generally accepted auditing standards (GAAS), and an annual independent financial audit. This chapter provides a detailed look at Federal auditing to better understand how it fits into the current management and accountability framework in place and the challenges ahead.

Audits of Federal Agency financial statements and programs play an important oversight role and add to the integrity and reliability of information reported. Most important, the oversight provided through independent audits, whether conducted by the Government Accountability Office (GAO) as an arm of the Congress, agency Inspectors General (IG), or independent Certified Public Accounting (CPA) firms, enhance accountability over Federal spending, stewardship, and program management. In essence, auditing is as essential to our government as the separation of powers itself.

## AUDITING AND GOVERNMENT

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The practice of auditing dates back millennia, with its roots more in the public sector than the private sector. Interestingly, these earlier audits were not merely fiscal or financial in nature but often addressed broader accountability, stewardship of assets, and legal compliance with respect to the receipts, disbursements, and uses of funds. Frequently, the sovereign or government's assets, administered by agents, were the impetus for periodic audits. In America, however, it was the government's Treasury and finances that were a concern to citizens and legislators. The priorities of colonial auditors closely paralleled those of today: conformance to budgets, completeness of reported receipts, appropriateness of expenditures, application or use of tax monies, and compliance with laws.<sup>3</sup>

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<sup>3</sup> Williams Holmes, Linda H. Kistler, and Louis S. Corsini, *Three Hundred Years of Accounting in Massachusetts* (New York: Arno Press, 1978).



Over the course of two centuries, the practices and ongoing problems of auditing perplexed many, confounded multitudes, and seemed to be the source of never-ending legal suits, trials, and judgments. No one had definitive views on what constituted an acceptable audit: not the Federal Government, courts, the public, or the accounting profession. Many attempts were made to set auditing standards and mandate specific auditing practices, and generally these promulgations were appropriate and applied. But, in many instances, when it was not possible to anticipate or provide for all of the circumstances and conditions that might be encountered in an audit, legislators, regulators, and standard setters told the auditor to “use judgment.” At times, the judgment exercised was in conflict with or was challenged by regulators, recipients, and other users of auditor reports. This was evident in the print and electronic media coverage of the 1990s and early 2000s reporting on numerous accounting, financial, and audit inadequacies. In many instances, the contested audit practices involved publicly traded corporations. Reviews of court dockets and governmental administrative law courts disclose similar disputes involving the Federal and other governments.

Standards for audits of Federal entities are similar to those applied in audits of private sector organizations. Like private sector audits, Federal audits must satisfy several constituencies: legislative overseers, Federal regulatory agencies, the rules of other Federal departments, and a host of accounting and auditing standard developers. The result is that the practice of Federal auditing must conform to a patchwork of laws, regulations, rules, customs, and practices, enunciated by a patchwork of congressional committees, governmental agencies, offices, and boards, and nongovernmental groups.

## **AUDITING THE FEDERAL GOVERNMENT: DEFINITION AND SCOPE**

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In the 1970s, the U.S. General Accounting Office<sup>4</sup> declared that audits of government needed to be more comprehensive and would require, if not entirely different audit standards, then the application of additional standards. These standards would address issues, beyond the financial, important to accountability in the Federal Government and by governments, organizations, entities, and others involved with, or benefiting from, Federal financial assistance. Thus, GAO issued generally accepted auditing standards for government entitled the *Government Auditing Standards* (informally referred to as the Yellow Book). The Yellow Book defined an *audit* as:

A term used to describe, not only work done by accountants in examining financial statements, but also work done in reviewing (1) compliance with laws

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<sup>4</sup> In 2004 the General Accounting Office changed its name to the Government Accountability Office, which will be used hereafter in this chapter and succeeding chapters, with the recognition that citations of Federal laws, regulations, rules, and standards prior to 2002 refer to the General Accounting Office.

and regulations, (2) economy and efficiency operations, and (3) effectiveness in achieving program results. The objective of such an examination includes an expression of the fairness of presentation of an entity's financial statements, but additionally a reporting, or an audit opinion if sufficient audit work was performed, on the nature of tests made and results of those tests with respect to an entity's system of internal controls and its compliance with laws and regulations and provisions of contract and grant agreements.

The focus of Federal audits includes not only audits of an organization's financial statements, but may include concurrent assessments and attestations relating to an organization's performance, management, compliance with laws and regulations, and effectiveness of financial controls. The premise is that financial statement audits are important and will continue to be so, but audits of only financial data, as of a specific point in time, provide limited information as to whether an organization is economical or efficient, or if its operations even approach operational objectives defined in enabling legislation.

In the most recent edition of *Government Auditing Standards* (December 2011; effective for financial audits and attestation engagements for periods ending on or after December 15, 2012, and for performance audits beginning on or after December 15, 2011), the current Comptroller General declares:

Audits provide essential accountability and transparency over government programs. Given the current challenges facing governments and their programs, the oversight provided through auditing is more critical than ever.

Beginning in the mid-1980s, congressional interest, special investigations, hearings, and new laws created significant audit opportunities for more and better audits of Federal activities. By the late 1990s, the significance of governmental auditing increased and the number of governments undergoing annual audits rose enormously. These laws mandated better audits: audits that focused on the broader issues of Federal Government, were more informative and of greater use to Congress and executive managers, and provided financial and operational perspectives to Federal overseers.

Auditing and accounting professionals from various groups are involved with auditing and reporting on the activities of the Federal Government. Although many of these professionals are employed by the government, many others are employed by independent CPA firms to conduct audits under contracts from Federal Agencies. The practice of Federal auditing encompasses Federal Agency systems, internal controls, accounting, and financial statements required by Federal laws and government regulations as well as the entities receiving Federal financial assistance programs in whatever form (e.g., Federal subsidies; contracts and grants; loan and loan guarantees; settlement overruns and over-head disputes; and resolution of allowable, unallowable costs, and indirect cost issues).

Audits of all types have played, and will continue to play, a valuable role in the oversight and management improvement of government programs. Unlike most private sector audits where assurance over financial statements is the primary objective, in government, many Federal Government audits are undertaken when a problem is suspected or a risk level is elevated. In Federal financial management as well as other areas, audits frequently serve as catalysts and provide leverage for management improvements. Annual agency financial and program audits have helped to provide a roadmap and guidepost for ongoing management improvements and the perpetuation of sound accounting disciplines and operations.

## **FEDERAL AUDITING: WHO SETS THE STANDARDS?**

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Several organizations, governmental and nongovernmental, by law or otherwise, have accrued significant statutory and other authority to prescribe standards for audits of Federal Agencies and of financial assistance provided to non-Federal entities through contracts, grants, and other agreements. In addition to laws of Congress establishing overall Federal audit policy, other organizations, in and out of the Federal Government, have been instrumental in defining or impacting the scope of Federal audits. These organizations include: the American Institute of Certified Public Accountants (AICPA); the U.S. GAO; the U.S. Office of Management and Budget (OMB); and Federal IGs.

### **American Institute of Certified Public Accountants**

Presently, the AICPA prescribes GAAS that form the underlying foundation of the *Government Auditing Standards* used by all auditors when auditing any Federal entity or recipient of Federal financial assistance. Federal audits must satisfy the AICPA's GAAS, which include general, fieldwork and reporting standards, plus the AICPA's *Statements on Auditing Standards*.

The Federal Government's reliance on GAAS was noted in the initial issuance of the *Government Auditing Standards* in 1972 and confirmed in all revisions since. In various sections, GAO stated that *Government Auditing Standards* incorporate all of the AICPA's fieldwork and reporting standards for audits and its *Statements on Auditing Standards*, unless the Comptroller General (who heads the GAO) excludes such standards by formal announcement. To date, no Comptroller General has excluded any AICPA fieldwork or reporting standards or *Statement on Auditing Standards*.

### **U.S. Government Accountability Office**

The GAO, a Federal Agency in the legislative branch, was established by Congress in 1921 to be its audit, evaluation, and investigative arm. GAO's founding legislation, the Budget and Accounting Act, provided that a core responsibility of GAO was to investigate, at the seat of government or elsewhere, the *receipt, disbursement, and application* of public

funds and to report annually to Congress on its work and recommendations for needed legislation. GAO, completely independent of the executive branch and accountable only to Congress, is headed by the Comptroller General. The Comptroller General is appointed by the President and serves with the advice and consent of Congress for a 15-year term of office. The Comptroller General cannot be reappointed and can be removed from office only by way of formal impeachment proceedings by Congress.

In 1972, GAO issued the initial edition of the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, a title later shortened to the *Government Auditing Standards* and popularly referred to as the Yellow Book, a reference to the cover's color. The Comptroller General declared in the *Government Auditing Standards* that audits involving public funds, Federal, and other public monies, may not be limited to those financial statement audits annually made by CPAs and other auditors. The *Government Auditing Standards* govern audits of financial statements, assessments, and attestations with respect to an entity's compliance with laws and regulations and controls over financial reporting, as well as performance audits. The most recent Yellow Book was released in December 2011 and includes a new conceptual framework for determining independence among other updates to standards.

### **U.S. Office of Management and Budget**

The Office of Management and Budget, an agency in the Federal Government's executive branch, and within the Executive Office of the President, has the primary responsibility of assisting the President with development and implementation of the Federal Government's budget, providing management policy guidance, and generally overseeing the performance of Federal cabinet departments and other agencies, boards, and commissions of the Federal Government. OMB was organized in 1970, but its predecessor, the Bureau of the Budget, dates back to the 1940s. Earlier, the Budget and Accounting Act of 1921, which established GAO, also established a Federal budget office within the U.S. Treasury Department.

In legislation such as the Chief Financial Officers (CFO) Act of 1990, Government Management Reform Act of 1994, and other laws of the 1990s relating to financial management, Congress delegated to OMB responsibilities for Federal accounting, auditing, systems oversight, and other financial management tasks. In exercising these responsibilities, OMB prescribed detailed policies and procedures to be applied in audits of Federal departments, agencies, and their activities. The policy announcements appear in a series referred to as OMB Circulars and OMB Bulletins, which are government-wide regulations and directives detailing how Federal departments and agencies are to implement laws of Congress.

### **OMB Circulars and Bulletins**

OMB Circulars are issued when the nature of a subject is of continuing effect and remain in force until rescinded or superseded. Circulars are identified by the prefix "A"

and a number. For example, OMB Circular A-133, titled *Audits of States, Local Governments, and Non-Profit Organizations*, sets forth the Federal audit policy, regulations, standards, and, in some instances, detailed audit procedures that must be employed when auditing recipients of Federal financial assistance. OMB Bulletins are used either when the nature of the subject requires a single or ad hoc action by Federal departments and agencies or when the issue is transitory in nature. The last two numerals of the fiscal year are used to indicate the annual series of bulletins and the sequential number of the specific subject matter. For example, an OMB Bulletin affecting Federal audits: OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements* (issued on September 4, 2007 and subsequently amended), provides OMB's guidance related to Federal financial statement audits.

### **Offices of Federal Inspectors General**

Within the executive branch there exist councils of Federal IGs established by presidential executive order to address integrity, economy, and effectiveness issues that transcend individual government agencies. This council is named the Council of Inspectors General for Integrity and Efficiency (CIGIE). One of the CIGIE's functions is to jointly issue, with GAO, the *Financial Audit Manual (FAM)*, which lays out an approach to conducting Federal financial audits. A major function of this council is to conduct inter-agency and interentity audit, inspection, and investigation projects to promote economy and efficiency in Federal programs and operations and to address government-wide issues of fraud, waste, and abuse more effectively. Collectively, IGs develop audit and investigation policies, standards, and approaches, and issue mandatory audit guidance relating to audits of Federal departments and agencies as well as audits of non-Federal entities receiving varying forms of Federal financial assistance.

The passage of the Inspector General Act of 1978 created, in the larger Federal Agencies, an Office of Inspector General with the responsibility to conduct and supervise audits and investigations of their respective agencies. The law provided that these IGs would be appointed by the President and serve with the counsel and consent of Congress. While IGs may be removed from office by the President, the President must communicate the reason for the removal to Congress. So while IGs serve at the will of the President, they have had more of a lasting presence from administration to administration, unlike other political appointees, including CFOs. In these agencies, the 1978 law required that there be an assistant IG for auditing responsible for supervising performance of all auditing activities relating to the agency's programs and operations.

### **TYPES OF GOVERNMENTAL AUDITS**

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When applied to corporate entities, the term *audit* is used primarily in reference to financial statement audits. Such audits are annually made of each required Federal

**EXHIBIT 1.1 Types of Audit and Attest Engagements**

<i>Engagement Type</i>	<i>Engagement Objective</i>	<i>Criteria</i>	<i>Standards Used to Perform Engagement</i>	<i>Who Can Perform</i>	<i>Type of Assurance</i>
Financial Audit	Opinion that the entity's financial statements are presented fairly	GAAP	GAGAS, including standards issued by the AICPA	GAO, IG, state and local government auditor, or CPA firm	Reasonable assurance
Attestation Examination	Opinion that management's assertion is stated fairly	Will vary depending on the management assertion	GAGAS, including standards issued by the AICPA for attest engagements	GAO, IG, state and local government auditor, or CPA firm	Reasonable assurance
Attestation Review	Performance of sufficient work to provide a conclusion (versus an opinion) on a topic or matter	Will vary depending on the audit objective	GAGAS, including standards issued by the AICPA for attest engagements	GAO, IG, state and local government auditor, or CPA firm	Negative assurance
Attestation Agreed-Upon Procedures	Performance of specific procedures defined by management	Will vary depending on the audit objectives	GAGAS, including standards issued by the AICAP for attest engagements	GAO, IG, state and local government auditor, or CPA firm	No assurance
Performance Audit	Assessment of program efficiency and effectiveness	Will vary depending on the audit objective	GAGAS	GAO, IG, state and local government auditor, or CPA firm	Reasonable assurance

GAGAS: generally accepted government auditing standards

Source: AGA Corporate Partners Advisory Group Research Report No. 19, *Procuring Audit Services in the Government—A Practical guide to Making the Right Decision*, 2009

department and agency.<sup>5</sup> Additionally, however, during the course of a fiscal year, a far greater number of audits is made under other descriptors, such as *attestation examinations*, *agreed-upon procedures*, *contract and grant audits*, and *performance audits*, to note a few. These special-focus audits are, for the most part, done by auditors of IG staffs, but a smaller number are also done by independent CPAs under contract to Federal Agencies.

Exhibit 1.1 highlights various types of audits and attest engagements used in government, the objective of each engagement type, criteria commonly used, relevant standards, who can perform these audits, and the type of assurance being provided. Most common are financial and performance audits; however, other less common types of engagements may be

<sup>5</sup> Includes the 24 CFO Act agencies and agencies subject to the Accountability of Tax Dollars Act of 2002, as documented by OMB.

used where circumstances dictate. For example, an attestation examination may be used to provide assurance over an assertion made by management. Additionally, agreed-upon procedures (AUP) are also useful engagements for accomplishing oversight in selected areas of interest to management. AUPs are defined by management, so they are flexible and can be adapted to particular circumstances. AUPs have been used in the past as an oversight tool by Treasury.

## **Financial Audits**

### ***Financial Statement Audits***

Financial statement audits are audits primarily concerned with providing reasonable assurance as to whether the annual financial statements of Federal departments and agencies are presented fairly in all material respects in conformity with GAAP or another comprehensive basis of accounting.<sup>6</sup> For financial statement audits, an auditor would render an audit opinion or a disclaimer of an opinion, depending on the results of the audit of the Federal entity's financial statements. Such audits would have to conform to the *Government Auditing Standards* issued by GAO.

### ***Other Financial Audits, Reviews, and Examinations***

*Nonstatement audits* may have a variety of audit scopes, objectives, and purposes that differ from financial statement audits. These nonstatement audits could include an audit opinion on a scope of less than an entity's entire financial statement, or the auditor's reporting could be in the form of a written assurance or attestation with respect to the audit work performed and the results of the audit.

If the audit objective is to express an opinion on financial statements, selected chapters of the *Government Auditing Standards* for financial statement audits apply. Of the seven chapters of guidance in the 2011 Yellow Book, the chapters listed below apply directly to financial audits:

- Chapter 1—Government Auditing: Foundation and Ethical Principles
- Chapter 2—Standards for Use and Application of GAGAS
- Chapter 3—General Standards, which applies to both financial and performance audits
- Chapter 4—Standards for Financial Audits

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<sup>6</sup> Only three authoritative organizations may establish GAAP for governments: Governmental Accounting Standards Board (GASB) (for state and local governmental units), Federal Accounting Standards Advisory Board (FASAB) (for Federal departments, agencies, commissions, and offices), and Financial Accounting Standards Board (FASB) (for state and local governmental units, but only upon specific recognition by GASB).

Other chapters of the Yellow Book relate to:

- Chapter 5—Standards for Attestation Engagements
- Chapter 6—Fieldwork Standards for Performance Audits
- Chapter 7—Reporting Standards for Performance Audits

### Performance Audits

The term *performance auditing* evolved during the 1950s and, in practice, connotes types of reviews other than financial statement audits. Other descriptors for performance audits include management evaluations, operational reviews, comprehensive audits, and compliance examinations. Defined by GAO, a performance audit entails:

An objective and systematic examination of evidence to provide an independent assessment of the performance and management of a program against objective criteria as well as assessments that provide a prospective focus or that synthesize information on best practices or cross-cutting issues.

Thus, GAO views a performance audit as one with audit objectives related to:

- Assessing a program's effectiveness, program results, or achievements
- Relative economy and efficiency with which an activity is operated
- Internal or management controls
- Value-for-money audits
- An entity's compliance with laws and regulations

Because these audits may address a variety of objectives, it follows that they must be performed to different criteria. Each performance audit is unique with varying scopes of work and will usually result in an auditor's report that sets forth the audit findings, conclusions, and recommendations. The *Government Auditing Standards* do not mandate a specific or described audit report for performance audits. Rather, the *Standards* state that the form of a performance audit report should be appropriate for its intended use and be written or in some other retrievable form considering the users' needs, likely demand, and distribution.

The chapters of the *Government Auditing Standards* applying directly to performance audits, whether such audits are performed by staffs of IGs or independent accountants under contract to a Federal Agency are listed below:

- Chapter 1—Government Auditing: Foundation and Ethical Principles
- Chapter 2—Standards for Use and Application of GAGAS
- Chapter 3—General Standards
- Chapter 6—Fieldwork Standards for Performance Audits
- Chapter 7—Reporting Standards for Performance Audits



In many instances, the objectives of performance audits are exclusively financial in nature, but they can assess operational performance, compliance with laws and regulations, effectiveness of managerial controls, or other scopes, limited only by those requiring auditor assistance. The automatic application of performance auditing standards to financial audits, or vice versa, is not appropriate and may be prohibited by Federal legislation. Performance audits are useful because they are flexible and can be adapted to review different programs using varying criteria. For example, as a follow-on to a financial audit, a performance audit can be used to hone in on a particular area of concern. Performance auditing will be addressed further in Chapter 14 of this book.

### **Other Attest Engagements**

#### ***Settlement Audits***

The term *settlement audit* could refer to any number of examinations and reviews that are unique to the public sector. Other descriptors include: turnover audits, transition audits, discharge audits, year-end encumbrance/obligation audits, and carry-forward audits. All are examinations or reviews with the objective of determining year-end account cut-off balances and amounts that could be due to or from *accountable officers*.

Settlement or discharge audits of accountable officers have a long precedence in the United States, dating to the early 1600s and 1700s. At the conclusion of these earlier settlement audits, the auditor was required to read the account to an audit committee of peers who concluded on the reasonableness of the accounting, after which the report would probably be submitted to the governing court.<sup>7</sup> Settlement audits are not full-scope financial statement audits but are more often an examination of the receipts, disbursements, and the propriety of the cut-off, or “turnover,” balance of an official’s “account.” In the Federal Government, there are several thousand *accountable officers* (e.g., collection officers, disbursing officers, cash custodians, and in some cases, certifying officers).<sup>8</sup> GAO is authorized by law to perform a settlement audit of the final financial reporting of these executives.

#### ***Financial-Related Audits***

Tens of thousands of audits are performed annually by those other than independent CPAs, for audits that do not include a financial statement within the scope, and the auditor’s report may or may not contain an auditor’s opinion. These audits might be generically referred to as *financial-related audits*. Financial-related audits, routinely performed by the internal auditors of governments, significantly outnumber annual financial statement audits.

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<sup>7</sup> Holmes, Kistler, and Corsini, *Three Centuries of Accounting in Massachusetts*.

<sup>8</sup> The Federal Joint Financial Management Improvement Program statistic appears in a study of accountable officers and the effectiveness of disbursement control procedures.

Financial-related audits have several common features:

- The audit scopes of these audits will differ from those of the annual statement audits performed in accordance with GAAS.
- The auditor's report will most often be in narrative form (e.g., detailing what was audited, what was found, and the auditor's recommendations) in contrast to the financial statement short-form opinion-type reporting, wherein the auditor states: "In our opinion . . ."
- In the vast majority of instances, these audits are performed by thousands of internal auditors employed by tens of thousands of governments.

## **ORGANIZATION OF THE BOOK**

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The book is divided into four parts to address interests of a diverse constituency that, at times, might well include legislators and their staffs, Federal, state, and local Governmental program managers and analysts, financial managers and accountants who must regularly undergo audit, and those doing business with the government.

### **Part I: Background of Federal Auditing**

Part I consists of four chapters that provide a foundation to understand the general nature of a Federal audit, the legal mandates, and the types of audit organizations that have authority and responsibility to conduct Federal audits and the conditions and restraints of such audits.

Chapter 1 highlights some of the history of auditing in the Federal Government, provides a description of auditing as practiced by Federal Agencies, and identifies the regulations requiring the various types of audits conducted of activities involving Federal Agency operations and financial assistance provided to non-Federal entities.

Chapter 2 identifies various laws which, over the past 200 years, have been the legal basis and precedent for audits made of Federal Agencies, Federal programs, and the government's contractors, grantees, borrowers, and those benefiting from any of many loan guarantee programs.

Chapter 3 describes Federal financial statements and requirements related to assessing and asserting on internal controls over financial reporting.

### **Part II: Federal Budgeting, Accounting, and Financial Statements**

Part II describes the accounting and audit significance of the Federal budget, economic events for which there must be an accounting and reporting, and an example of the financial statements required to make that accounting and reporting.

Chapter 4 describes, in general terms, the Federal budget process and its participants, budgetary events requiring an accounting and reporting, plus an overview of the accounting life cycle of Federal financial transactions.

Chapter 5 describes the form and content of several Federal financial statements, the purpose or objective of each statement, and the compilation process necessary to meet the advanced, accelerated Federal reporting mandates.

### **Part III: Auditing in the Federal Government**

Part III describes, overall and by specific phases, the process for planning, conducting, reviewing, and the ultimate reporting of a financial statement audit of a Federal Agency.

Chapter 6 describes major developments in auditing standards.

Chapter 7 provides an overview of the financial audit and briefly describes the processes, phases, and selected steps of an optimal plan for conducting the annual financial statement audit of a Federal Agency.

Chapter 8 discusses initial audit planning, including the development of an audit plan, and emphasizes the need to reassess plans as the audit progresses and new facts come to life.

Chapter 9 outlines an approach and procedures for documenting the auditor's understanding of an agency's internal controls over financial reporting.

Chapter 10 provides an overview of the development of an audit approach and audit procedures based on the auditor's evaluation of internal control and assessment of control risk.

Chapter 11 identifies audit procedures relevant to conducting tests of internal controls, transactions, accounts, account groupings, and line items of an agency's financial statements.

Chapter 12 discusses certain end-of-audit concerns, considerations, audit close-out tasks, and illustrates the types and content of auditor reporting that must be made to conform to *Government Auditing Standards*, including examples of audit reports.

### **Part IV: Nature of Selected Federal Audits**

Part IV describes types of audits made annually or periodically by auditors of Federal Agencies, their contractors and grantees, and other organizations that are recipients of Federal financial assistance. Also included is an overview schematic of suggested chronology and sequencing of the audit procedures and tasks for the more common audits.

Chapter 13 discusses auditing and evaluation of Federal information technology (IT) systems.

Chapter 14 defines performance auditing, identifies types of these audits and who conducts them, and provides a suggested audit methodology for such examinations.

Chapter 15 describes grant and contract audits.

Chapter 16 discusses attestation engagements, including agreed-upon procedures engagements.



# 2 FEDERAL AUDIT CRITERIA

## ***Laws, Regulations, Audit Standards***

The Federal Government and its constituent departments and agencies earn no income and have no profitability concerns. The Federal Government can, however, print money, write checks, borrow money, and spend. By law, Federal Agency executives are responsible for the accurate and timely accounting, controlling, and reporting of the receipts, disbursement, and application of public monies. For over 200 years, Congress, by legislation, has attempted to control these financial activities through a process that includes authorizing, appropriating, and budgeting authority approvals relating to raising and spending Federal funds. Other laws offer criteria directing Federal departments and agencies to better plan, manage, and monitor their operations and to do so in a more economical, efficient, and effective manner. These responsibilities lead to peculiarities and variations for Federal entities that are not the same for private sector organizations.

The financial management laws of direct concern to Federal financial executives and auditors of Federal operations and activities are listed next and described in more detail in this chapter. The provisions of these laws establish the financial and operational criteria that must be subjected to scrutiny during the annual independent audit of an agency's financial statements. Selected provisions of several of these laws and regulations are of direct concern to those conducting Federal audits. A close review of each law, in its entirety, must precede the development of an effective plan to audit a Federal department's financial statements, operations, activities, functions, and awarded contracts and grants in aid.<sup>1</sup>

### **Major Legislation to Establish Federal Financial Management Policy**

- The Constitution of the United States
- Anti-Deficiency Act of 1870
- Budget and Accounting Act of 1921
- Government Corporation and Control Act of 1945
- Budget and Accounting Procedures Act of 1950 (as amended in 1956)
- Supplemental Appropriations Act of 1951

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<sup>1</sup> An excellent reference source for many of these laws is the report *Laws Related to Federal Financial Management*, by the House of Representatives' Committee on Government Reform and Oversight, Washington, D.C., August 1996.

- Congressional Budget and Impoundment Control Act of 1974
- Inspector General Act of 1978, as amended
- Federal Managers' Financial Integrity Act of 1982
- The Single Audit Act of 1984 (as amended in 1996)
- Federal Credit Reform Act of 1990
- Chief Financial Officers Act of 1990
- Government Performance and Results Act of 1993 (as amended in 2010)
- Government Management and Reform Act of 1994
- Federal Financial Management Improvement Act of 1996
- Accountability of Tax Dollars Act of 2002
- Improper Payments Information Act of 2002 (as amended in 2010 and 2012)
- Department of Homeland Security Financial Accountability Act of 2004
- Federal Funding Accountability and Transparency Act of 2006

## **THE CONSTITUTION: "THE POWER OF THE PURSE"**

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All fiscal, financial, and operational responsibility is vested in the United States Congress under the Constitution. Over the years and through various laws, Congress has delegated aspects of that responsibility to selected *central agencies* (e.g., the Office of Management and Budget [OMB],<sup>2</sup> the Government Accountability Office [GAO], the Department of the Treasury, the General Services Administration [GSA], and the Office of Personnel Management [OPM]). These central agencies, in turn, publish more detailed government-wide regulations to implement the laws. Additionally, Congress grants broad discretion to the heads of each Federal Agency to determine appropriate managerial, accounting, systems, and controls over financial reporting and to establish the procedures and practices needed to effectively, efficiently, and economically manage the individual agency's operations, programs, and activities.

### **Constitutional Financial Authority**

The first and most basic financial management legislation referring to Federal revenues, disbursements, and the use of public monies appears in the Constitution itself. Portions of Article 1, Sections 8 and 9, outline what powers the drafters vested with Congress; for example:

- Section 8, Clause 1: "The Congress shall have the power to lay and collect taxes, duties, imposts, and excises to pay the debt and provide for the common defense and general welfare of the United States . . . "

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<sup>2</sup> Throughout this book, reference is made to the OMB with the recognition that laws and regulations prior to 1974 make reference to the Bureau of the Budget and other descriptors earlier in the country's history.

- Section 8, Clause 2: “To borrow money on the credit of the United States . . .”
- Section 9, Clause 7: “No money shall be drawn from the Treasury, but in consequence of appropriations made by law; and a regular statement and account of receipts and expenditures of all public money shall be published from time to time.”

This constitutional provision provides Congress with the “power of the purse.” No agency, program, activity, or function can be initiated, nor can Federal monies be expended by the President, without an earlier legal action by the Congress (i.e., the enactment of an authorization, appropriation, or budgetary authority, described in the following sections).

Each year, much is made of a President’s State of the Union address, and his budget is a key aspect of this annual speech. More accurately, though, the annual message is the President’s *proposed* budget for the Federal Government. Unless both houses of Congress agree with the President—and seldom are all of the President’s proposals accepted without change—there will be no budget; thus, the cliché: “The President proposes, Congress disposes.” When serious disagreements arise between the President’s and Congress’s views on the Federal budget for any fiscal year, the ramifications are serious. If Congress refuses to conclude on a budget for the Federal Government, the Federal Government shuts down, as in the government closures in 1996. More recently, policy disagreements between the President and Congress have resulted in heightened budget tensions and ongoing incremental funding in the form of continuing resolutions. This has resulted in a prolonged period of resource uncertainty, making both short- and longer-term planning more difficult.

### **Federal Budget Defined**

The *Federal budget* is the legal mandate of Congress to the President and heads of Federal departments and agencies to tax, collect, borrow, obligate, and expend money in the manner, only for the purposes, at the rate, and within the time period prescribed by Congress. The Federal budget, approved by both Houses of Congress, is, at one and the same time:

- A listing of national priorities, as determined by the Congress, for the next year and, in some cases, the next several years.
- Permission or direction to the executive branch to commence, continue, or cease operating specific governmental agencies, programs, and activities.
- The legal authority to collect revenues, incur and pay financial obligations, and borrow on the credit of the Federal Government.
- The financial plan for managing the Federal Government during the next fiscal year.
- The financial management policy dictating acceptable accounting, financial reporting, and audit policies and, at times, detailed procedures and prohibitions.

### Congressional Authorizing Legislation

Congress does not approve the President's requested budget as a single amount. Instead, the amount requested by the President is broken down and analyzed by several congressional committees and subcommittees that may approve, change, or disapprove of the President's proposal or even approve budget authority that was never sought by the President. During the legislative review phase, Congress will initiate committee hearings and, at times, turn budget issues into matters of considerable public prominence, widely reported in the news and electronic media.

By law, Congress must complete its appropriation process and approve a budget for the overall Federal Government by October 1 of each year. In recent years, many appropriations have not been made final by Congress until well after the new fiscal year has begun. The failure to pass a Federal budget results in Congress having to give temporary operational and spending authority to the executive branch; this legislation is referred to as a *continuing resolution*. The approved financial budget or authority takes the form of several pieces of legislation, that is, several individual *appropriations*, which, when summed, become the Federal Government's legal budget or financial plan for the fiscal year. Once passed by Congress, the individual appropriation laws, if not vetoed by the President, become the budget and spending authority, which is closely managed, monitored, accounted for, reported upon, and audited by Federal departments and agencies. Deviations from the provisions of authorization and appropriation legislation are statutory violations for which there must be a reporting to the President and to Congress.

### Major Budget and Financial Management Laws

The next chart summarizes the major budget and financial management laws in place today. Subsequent sections in the chapter discuss each one of these laws in greater detail.

<i>Major Budget and Financial Management Legislation</i>		
1870	Anti-Deficiency Act	Prevented executive departments and agencies from making expenditures in excess of amounts appropriated by Congress
1921	Budget and Accounting Act	The more significant provisions of this act affect Federal financial management policy, systems, controls, and practices to this day
1945	Government Corporation Control Act	Passed to provide for closer Congress scrutiny of government corporations and to require that these organizations undergo independent audits by the Comptroller General
1950	Budget and Accounting Procedures Act	Provided Congress with overriding accounting and reporting and more control over Federal receipts, expenditures, funds, and property



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*Major Budget and Financial Management Legislation*


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1951	Supplemental Appropriations Act	Permitted the President to submit annual budget on program accomplishments
1956	Amendments to the Budget and Accounting Procedures Act	Changed the Federal budgeting and financial process to assert more congressional control over the executive branch
1974	Impoundment Control Act	Established statutory criteria that defined what constitutes a valid obligation against a Federal appropriation
1978	Inspector General Act	Established Inspectors General (IGs) in Federal Agencies and gave them authority to oversee all audits conducted
1982	Federal Manager's Financial Integrity Act	Reflected increased concern by Congress over the adequacy of internal accounting and administrative controls in Federal executive agencies
1984	Single Audit Act, as amended in 1996	Required recipients of Federal financial assistance to undergo a single financial audit that could be leveraged; shifting the focus away from individual program-oriented audits of Federal financial assistance
1990	Federal Credit Reform Act	Required that the President's budget reflect the full cost of direct loan and loan guarantee programs, including new direct loan obligations or loan guarantee commitments
1990	Chief Financial Officers Act	Changed significantly the accounting and reporting of the Federal Government to include audited financial statements
1993	Government Performance and Results Act, amended in 2010	Requires Federal departments and agencies to develop strategic and performance plans and reports of major functions and operations, outcome-related goals and objectives, and a description of skills, technology, and resources required
1994	Government Management Reform Act	Required each Federal department and agency to submit, by March 1 of each year, an audited financial statement for the preceding fiscal year showing the financial position and the results of operations
1996	Federal Financial Management Improvement Act	Promoted more useful and reliable financial information through compliance with accounting standards, systems requirements and the standard general ledger
2002	Accountability for Tax Dollars Act	Extended audited financial statements to government corporations and other executive branch agencies
2002	Improper Payment Information Act, amended in 2010 and 2012	Requires Federal Agencies to identify, estimate, and reduce improper payments; requires agency IGs to annually audit management's compliance (now called the Improper Payment Elimination and Recovery Act of 2010)
2004	Department of Homeland Security Financial Accountability Act	Extended requirements for a chief financial officer (CFO) and audited financial statements to the newly created department; also required the department to obtain a separate audit opinion over internal control over financial reporting
2006	Federal Funding Accountability and Transparency Act	Required Federal Agencies to report grant and contract spending information on a government Web site

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## ANTI-DEFICIENCY ACT: CANNOT SPEND MORE THAN CONGRESS PROVIDES

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### The Act's Objective

Since the country's founding, Congress has battled the executive branch over fiscal excesses, perceived waste and mismanagement, and failures to adhere to spending laws. An objective of the Anti-Deficiency Act of 1870 was to prevent Federal executive departments from spending more than was appropriated by Congress. Later amendments to this law mandated specific procedural practices, such as requiring that Federal Agencies obtain formal approval from OMB of all funds appropriated by Congress. This OMB approval is referred to as an apportionment. An *apportionment* constitutes the authorization by OMB to a Federal Agency citing the amounts, purposes, and rates at which an agency may spend the funds appearing in its appropriation law. And, of course, no apportionment of funds by OMB can exceed the ceiling set by Congress in the appropriation itself.

### Section 3679 Audit Considerations

Within the Federal financial management community, probably the most quoted and most closely monitored legislation includes provisions of the Anti-Deficiency Act, referred to by accountants and auditors as Section 3679 Audits (of the Revised Statutes). Some of the key provisions having audit implications include:

- OMB is required to apportion or reapportion appropriated funds, in writing, either by:
  - Months, calendar quarters, operating seasons, or other time periods;
  - Activities, functions, projects, or objects;
  - Some combination thereof.
- No apportionment is permitted that would necessitate a deficiency or supplemental appropriation estimate unless such an action is required because of:
  1. Laws of Congress passed after the appropriation law that require additional expenditures;
  2. Emergencies involving safety of human life, protection of property, or immediate welfare of individuals, where an appropriation requires sums to be paid to such individuals.
- An officer of the government with administrative control of an appropriation is required to prescribe, by regulation, a system of administrative controls designed to:
  1. Restrict obligations or expenditures against each appropriation to the amount of the apportionment;

2. Enable such officer or agency head to fix responsibility for creation of any obligations or make an expenditure in excess of an apportionment or reapportionment.<sup>3</sup>

Other provisions of the Revised Statutes of concern to Federal auditors provide that no Federal officer or employee shall:

- Make or authorize an expenditure from, or create or authorize an obligation under, any appropriation or fund in excess of an amount available therein.
- Involve the government in any contract or obligation for payment of money for any purpose, in advance of an appropriation made for that purpose, unless such contract or obligation is authorized by law.
- Accept voluntary service for the United States or employ personal services in excess of that authorized by law, except in cases of emergency involving the safety of human life or the protection of property.
- Authorize or create any obligation or make expenditures in excess of an apportionment or reapportionment, or in excess of the amount permitted by agency regulations prescribed and approved pursuant to law.

### **Noncompliance Consequences**

Violation of any of these prohibitions requires that a Federal employee be subject to appropriate administrative discipline that could include suspension without pay or removal from office. The willful or knowing violation, upon conviction, may result in a fine of not more than \$5,000, imprisonment for up to two years, or both.

### **BUDGET AND ACCOUNTING ACT OF 1921**

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The Budget and Accounting Act of 1921 led to some important improvements and changes in Federal financial management:

- The establishment of a government-wide budget system and creation of the Bureau of the Budget (BoB), the predecessor to OMB within the Department of the Treasury.
- Creation of the General Accounting Office (renamed the Government Accountability Office in 2004) as an independent agency in the legislative branch, headed by the Comptroller General, and accountable only to Congress.

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<sup>3</sup> These Federal executives, one or more of whom reside in every Federal Agency, are referred to as *accountable officers*.

- Vested in GAO the powers earlier held by the comptroller of the Treasury and the six auditors of Treasury with respect to prescribing fiscal practices, forms and procedures for administrative control, and accounting for appropriated funds.
- Amendments later gave GAO the authority to settle and adjust all claims and demands by or against the government.

Although revised, in part, by subsequent legislation, the Budget and Accounting Act of 1921 required the Comptroller General to prescribe forms, systems, and fund accounting for all Federal departments and establishments and to examine fiscal officer accounts and claims against the United States.

### **Audit and Examinations of the Government and Others**

GAO was given the responsibility of examining fiscal officers' accounts and claims against the government and for investigating "at the seat of Government and elsewhere" all matters relating to the receipt, disbursement, and application of Federal funds. To fulfill these responsibilities, Congress provided GAO with the right to access and examine any books, documents, papers, records of Federal departments, or establishments. This right was later expanded to include the right to access and examine records and documents of Federal contractors and grantees insofar as those records related to the expenditure of Federal monies.

### **BUDGET AND ACCOUNTING PROCEDURES ACT OF 1950: STRENGTHENED FEDERAL FINANCIAL PRACTICES**

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With the implementation of the Budget and Accounting Procedures Act of 1950, Congress attempted to amend provisions of the Budget and Accounting Act of 1921 and impose improvements requiring that:

- Federal accounting provide full disclosure of results of financial operations, adequate financial information needed in management of operations and formulation and execution of the budget, and effective control over income, expenditures, funds, property, and other assets.
- Full consideration be given to the needs and responsibilities of both the legislative and executive branches in establishing accounting and reporting systems requirements.
- The maintenance of accounting systems and the production of financial reports, with respect to operations of executive agencies, bring together and disclose information of the government as a whole will be the responsibility of the executive branch.
- Auditing of the Federal Government will be conducted by the Comptroller General as an agent of the Congress and is to be directed at determining:

- The extent to which accounting and related financial reporting are for the purposes specified in law.
- Financial transactions have been consummated in accordance with laws, regulations, and other legal requirements.
- Adequate internal financial control over operations is exercised and affords an effective basis for settlement of and accounts of accountable officers.
- The Comptroller General, the Secretary of the Treasury, and the BoB conduct a continuous program for improvement of accounting and financial reporting, a responsibility that continues to this day under the auspices of the Joint Financial Management Improvement Program.

### **Audit Principles and Standards**

Regarding GAO's new auditing responsibilities, the Budget and Accounting Procedures Act of 1950 stated that GAO's audits should include, but are not be limited to, the accounts of *accountable officers*. *Accountable officers* are specially designated Federal executives who reside in all Federal Agencies. Further, the act stated that the GAO audit was to be conducted in accordance with the principles and standards prescribed by the Comptroller General. The audit and examination procedures were to give due regard to generally accepted "principles" of auditing, including consideration of the effectiveness of accounting organizations and systems, internal audit and control, and related administrative practices of Federal Agencies. To this day, GAO continues to prescribe audit standards, to wit: the *Government Auditing Standards* (Yellow Book), the 2011 edition of which is the latest revision.

### **SUPPLEMENTAL APPROPRIATIONS ACT OF 1951: DEFINE THE LEGAL FORM FOR FEDERAL OBLIGATIONS**

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The Supplemental Appropriations Act of 1951 statutorily established the criteria for valid obligations and claims for payment under Federal appropriations. If a claim fails to conform to the criteria in this act, the claim is not a valid obligation of the United States and cannot be paid.

According to Section 1311 of this act, no amount shall be recorded as an obligation of the government unless it is supported by one of the eight prescribed forms of documentary evidence. Congress intended that these eight forms of documentary evidence (defined in more detail in Chapter 4) encompass the full range of the types of obligations that could be legally incurred by an agency in the course of its operations.

The Supplemental Appropriations Act requires that every agency report at year-end, for each appropriation and budget authority, the unliquidated obligations and remaining unobligated appropriation balances. This report must be certified by those agency officials formally designated as having the responsibility for recording and monitoring obligations.

This reporting also initiates a special Federal year-end audit known government-wide as a 1311 or year-end or unliquidated obligations audit.

### **IMPOUNDMENT CONTROL ACT OF 1974: CONGRESSIONAL BUDGET OFFICE, NEW FISCAL YEAR, AND MORE**

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The need for the Impoundment Control Act arose as a result of a financial dispute between the Office of the President and Congress over the expenditure of congressionally appropriated monies. While earlier congressional concerns were primarily focused on the potential overexpenditure of appropriated funds, this particular instance focused on the President's decision *not* to spend appropriated funds in an attempt to reduce Federal expenditures that Congress at the time was not likely to do so. Thus, the Office of the President "impounded," restricted, reserved, froze, or otherwise reduced spending by Federal Agencies to amounts below those appropriated by Congress. The Impoundment Control Act, with few exceptions, prohibited future impoundments of appropriated monies. If an impoundment of appropriated funds was requested, advanced notification had to be provided to Congress and fully disclosed to the public. Except as otherwise authorized in the act, Congress stated that no reserves of an appropriation shall be established.

#### **Other Provisions: New Budget Process, New Agency, New Fiscal Year**

For years preceding the passage of the Impoundment Control Act of 1974, Congress had been in violation of its own laws, as well as the Constitution, with respect to budgeting and financial accountability. This act established a new budget process, attempted to impose more control over the financial activities of the executive branch, and brought greater discipline to Congress itself.

In subsequent years, however, Congress, more so than the executive branch, was in violation of the Impoundment Control Act. For example, by the 1974 act, Congress:

- Established a new budget process for itself, which included, among other items, setting up a committee of the budget in each house of Congress to force the many committees to coordinate and agree on revenue and expenditure levels in advance. This was done to impose fiscal and operational controls over the members and to impose a discipline of appropriation on other congressional committees with respect to planned expenditures and growing deficits.

The committees of the budget may not always have been ignored by members of Congress, but the budget committees were never among the stronger of congressional committees and often were not particularly instrumental or successful in the enforcement of budget discipline.

- Established the Congressional Budget Office (CBO) to provide Congress with a professional counterweight to challenge and otherwise critique the budget data provided to it by OMB and agencies of the executive branch. CBO has since

provided that service and has also acquired a reputation, among the general public, of being an independent and honest broker of calculations, forecasts, and estimates of budget data.

At times, to the chagrin of Congress, the President, and OMB, CBO lacked reticence in publicly pointing out where Congress, the President, or OMB may not have always provided the public with the fullest, clearest explanations or the full impact of details embedded in the trillion-dollar budget of the Federal Government.

- Mandated a new fiscal year for the Federal Government, changing it from July 1 of each year to October 1. The reason for the change was viewed, at the time, as specious and considerably more expensive than the benefit alleged by Congress. For many years, Congress had been remiss in providing an approved budget (i.e., enacting of all required appropriation laws) for the Federal Government to be effective on July 1, the first day of the government's fiscal year since the country's founding. By changing the fiscal year, Congress bought itself another three months in the single year of transition.

But, in the years following passage of this act, Congress repeatedly failed to complete its budget work by the newly established deadline. This was the case on October 1, 2004, the first day of fiscal year 2005. To avoid a shutdown of the government, Congress provided temporary financing to Federal Agencies (referred to as a *continuing resolution*) that potentially could have continued for weeks, even several months, into the new fiscal year.

This act, the budget process, budget cycle, and some of the budget strategies applied or used in the Federal Government are discussed in more detail in a later chapter of the book.

## **INSPECTOR GENERAL ACT OF 1978**

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The Inspector General Act of 1978 created independent and objective units within departments and agencies to conduct and supervise audits and investigations. It is the intent of Congress that Federal IGs provide leadership and coordination in preventing fraud and promoting economy, efficiency, and effectiveness. In addition, IGs are expected to keep Congress, the President, and top agency executives abreast of important developments within their individual agencies.

## **FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT OF 1982**

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The Federal Managers' Financial Integrity Act of 1982 (FMFIA) displayed Congress's continuing concern over the financial management practices of the Federal Government. FMFIA required that systems of accounting and administrative controls be established and

that each agency annually conduct an evaluation and report to the President and the Congress on the adequacy of these systems.

Selected provisions of the act that could impact the nature of tests made when conducting a Federal audit might be those provisions that require each executive agency to provide reasonable assurances that:

- Systems of internal accounting and administrative controls are in accordance with standards prescribed by the Comptroller General.
- All obligations and costs of a Federal Agency comply with applicable laws.
- All Federal funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation.
- Revenues and expenditures of agency operations are properly recorded and accounted for to allow preparation of accounts and reliable financial and statistical reports, and to maintain accountability over assets and other resources.
- Heads of Federal Agencies shall evaluate, prepare, and submit a statement to the President affirming that the agency's systems of internal accounting and administrative controls fully comply with the guidelines established by the Comptroller General in consultation with OMB, pursuant to this act.
- The President, in submitting the budget request to Congress, shall include a separate report on whether the agency's accounting system conforms to the principles, standards, and related requirements prescribed by the Comptroller General.

Agencies continue to conduct reviews of their systems of accounting and administrative controls and make reporting pursuant to the FMFIA of 1982 and later legislation.

## **SINGLE AUDIT ACT OF 1984: ONE AUDIT, ONCE A YEAR, BY ONE AUDITOR**

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### **Historical Problems with Audits of Federal Grantees**

In the 1950s, problems arose with the manner in which the Federal Government performed audits of state and local governmental entities and other organizations receiving Federal financial assistance. These problems were cataloged by the GAO and government-wide studies and were the subject of numerous congressional committee hearings into the 1980s. Examples of the Federal Government's problems and the ripple-type problems created at the state and local government levels were numerous but fell into a few general categories:

- Excessive duplication of Federal audit by many agencies with no coordination or cooperation
- Biased audit reports, since many audits were reported to senior executives under the audit who had the authority to make changes and did change audit reports for the "better"



- Federal resistance to transferring audit responsibility to state and local government auditors, despite laws, regulations, and policy statements directing that this be done
- Prohibiting, preventing, or resisting the sharing of Federal audit findings with senior executives of other governments, or giving the public access to such reports

Initially passed in 1984 and amended in 1996, the Single Audit Act ordered Federal organizations to implement an audit concept whereby recipients receiving \$500,000 or more of Federal assistance need undergo only one audit each year. The results of this single audit would then be shared with all organizations having a financial interest in that recipient. Further, the act declared that audits made in accordance with the Single Audit Act “shall be in lieu of any financial audit of Federal awards which a non-Federal entity is required to undergo under any other Federal law or regulation.” This act changed the historical focus of Federal oversight, eliminating financial and human resource costs related to thousands of duplicative and uncoordinated Federal audits and reviews.

### **Scope of a Single Audit, as Amended**

Studies submitted to Congress and witnesses appearing before committees of Congress relative to the 1996 amendments were uniformly supportive of the Single Audit Act. While improvements could be (and were) made, the consensus was that this law had instituted an efficient and effective audit concept contributing to an enormous reduction in overlap and duplication in comparison to earlier Federal audit approaches.

The legally defined comprehensive single audit required two things:

1. An annual financial statement audit must be made of the recipient of Federal funds in its entirety.
2. This annual audit must include tests and reports made on an entity-wide basis, and for each major Federal programs basis relative to:
  - a. Financial controls and controls to manage the Federal assistance programs.
  - b. Compliance with laws and regulations for major Federal award programs.

These single audits were required to be made pursuant to GAO’s Yellow Book plus the audit procedures and reporting requirements in OMB Circular A-133, *Audits of State and Local Governments and Non-Profit Organizations*, as amended.<sup>4</sup>

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<sup>4</sup> When first enacted, the Single Audit Act of 1984 was implemented through two separate OMB circulars: OMB Circular A-128 for Audits of State and Local Governments and OMB Circular A-133 for Institutions of Higher Education and Nonprofit Entities. In 1997, OMB Circulars A-128 and A-133 were replaced and superseded by a single circular, titled OMB Circular A-133, *Audits of State and Local Governments and Non-Profit Organizations*, last amended in June 2003.

**Working Papers: Access, Retention**

The Single Audit Act addressed the need for access to working papers by requiring that working papers be made available to a Federal Agency or the Comptroller General of the United States, upon request, to carry out audit and oversight responsibilities. Such *access*, by law, included the right of the Federal Government to obtain copies. OMB Circular A-133 in turn required auditors to retain the working papers for a minimum of three years after date of issuance of the auditor's report, unless the auditor is notified in writing by a Federal cognizant agency or oversight agency or a pass-through entity to extend the retention period beyond the three-year minimum. When the auditor becomes aware that an audit finding is being contested, he or she must contact the contesting parties for guidance prior to destruction of the working papers and reports.

**Single Audit Act: Application**

Congress in the Single Audit Act and OMB in its Circular A-133 provided the following definitions of *awards*, *financial assistance*, and *major program* that Congress wanted audited and opined upon:

*Federal awards.* Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities.

*Federal financial assistance.* Assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but not amounts received as reimbursement for services rendered to individuals in accordance with guidance by the director of OMB.

*Federal program.* Federal awards and financial assistance that have been assigned a number in the OMB Catalog of Federal Domestic Assistance or encompassed within a group of numbers.

*Major program.* A Federal program, identified by OMB, that must, by the act, be audited and opined on and reported on, would generally be each individual Federal program whose expenditures in a single year exceed the larger of \$300,000 or 3 percent of the total Federal expenditures for that non-Federal entity.

**Additional "Standards" for Single Audits**

The Single Audit Act, Yellow Book, and OMB Circular A-133 in combination comprise the audit reporting "standards," or criteria that must be met if the single audit is to

comply with the law. This combination of the Act, GAO's audit standards, and OMB regulations requires that an audit report for a single audit be a package of up to 12, and possibly more, reports, some with audit opinions, some with audit assurances, and some transmitting information required by the Federal overseers.

Unless specifically required by OMB, the scope of a single audit does not automatically encompass performance audits.

### **FEDERAL CREDIT REFORM ACT OF 1990: FULL COST OF LOANS AND LOAN GUARANTEES MUST BE BUDGETED**

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The Federal Credit Reform Act of 1990 is not well known because few Federal Agencies are authorized to make loans or enter into loan guarantee transactions. In addition, upon its original passage into law, this act was part of Federal Government's general Omnibus Reconciliation Act of 1990. But the Federal Credit Reform Act significantly changed financing, accounting, and reporting for Federal loans and loan guarantees. These financial assistance programs included some of the more popular of the government loans, including farmers' home loans, small business loans, veterans' mortgage loans, and student loans.

The Federal Credit Reform Act required, for the first time in history, the President's budget request to reflect the full cost of direct loans and loan guarantee programs, including the planned level of new loan obligations and loan guarantee commitments associated with each appropriation request. Congress, in the act, stated that the purposes of the act were to:

- Ensure a timely and accurate measure and presentation in the President's budget request of the full costs of direct loan and loan guarantee programs.
- Place the cost of credit programs on a budgetary basis equivalent to other Federal spending.
- Encourage the delivery of benefits in the form most appropriate to the needs of beneficiaries.
- Improve the allocation of resources among credit programs and between credit and other spending programs.

This law concluded a 200-year history of accounting for less than the full cost of Federal loans and loan guarantees. Federal departments and agencies now had to recognize, at the time of legislative action, the true cost that these programs were likely to incur, such as projected default costs, interest subsidy costs, and recognition, at the time of

loaning, the current market rate of interest. To accomplish its objectives, the act's provisions required that:

- For each fiscal year in which the direct loans or the loan guarantees are to be obligated, committed, or disbursed, the President's budget request reflects the long-term costs to the government of subsidies associated with the direct loans and loan guarantees. Prior to the act, such costs were not reflected in any fiscal year's accounting.
- Before direct loans are obligated or loan guarantees committed, the annual appropriations be enacted to cover the full costs of projected defaults, interest subsidy costs, and recognition, at the time of loaning, of the current market rate of interest.
- Borrowing authority had to be formally provided and recognized by the Treasury Department to cover the nonsubsidy portion of direct Federal loans.

Recording *interest subsidy* costs recognizes that Federal loans provide for payment of interest rates that were well below the going market rates. This lower interest rate, in essence, gave borrowers and recipients of loan guarantees a break or subsidy. To finance this subsidy, the Treasury Department was borrowing money at higher market interest rates.

Historically, agency accounts recorded only a cash disbursement and made no formal accounting for the future repayment (i.e., as a loan receivable) or possible default of the loan. This type of accounting avoided the embarrassing need of the Federal Government to recognize loan defaults and to later account for uncollected loans. This underrecognition of costs had been further compounded by having no accounting until the loan defaulted or the Federal Government had to make payment under a defaulted loan guarantee program. For the most part, these events happened years later, were not anticipated, and in the case of failures of hundreds of savings and loan associations and banks in the 1980s, resulted in billions of dollars of losses being passed along to later generations to finance.

#### **CHIEF FINANCIAL OFFICERS ACT OF 1990: UNIFORM REPORTING, AGENCY CFOs, ANNUAL FINANCIAL STATEMENTS, INDEPENDENT AUDITS**

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In the 1990s, congressional and executive branch interest in financial systems, controls, performance reporting, and other management improvement exceeded that of any decade in the preceding 200 years. The Chief Financial Officers Act (CFO Act) was typical of legislation enacted in the 1990s. In the CFO Act, Congress reaffirmed its intent to oversee and control the financial management process of the Federal Government and to centralize authority and responsibilities for better accounting, controls, and financial management. For the first time, department comptrollers were required to adhere to applicable accounting and reporting standards, annual financial statements by Federal entities, and independent audits of those financial statements.

### Concerns of Congress

The CFO Act was a significant, but partial, response to financial management issues known to Congress and the executive branch for decades. This was noted by the prefatory thoughts of Congress in the CFO Act that described a deteriorated financial reporting and internal controls environment within the Federal Government. Highlights included:

- Billions of dollars are lost each year through fraud, waste, abuse, and mismanagement among hundreds of programs in the Federal Government.
- These losses could be significantly decreased by improved management, including improved central coordination of internal controls and financial accounting.
- The Federal Government is in great need of fundamental reform in financial management requirements and practices as financial management systems are obsolete and inefficient, and do not provide complete, consistent, reliable, and timely information.
- Current financial reporting practices of the Federal Government do not accurately disclose the current and probable future costs of operating and investment decisions, including the future need for cash or other resources, do not permit adequate comparison of actual costs among executive agencies, and do not provide the timely information required for efficient management of programs.

Among several objectives noted in the CFO Act was the improvement in each agency's systems of accounting, financial management, and internal controls to assure issuance of reliable financial information to deter fraud, waste, and abuse of government resources.

### Financial Policy and OMB

By the CFO Act, Congress established separate deputy directors at OMB—one for budget and one for management. The Deputy Director of OMB for Management, a senior executive position, was established by the CFO Act, and the role of management in OMB for Federal financial management was significantly expanded. OMB was required to perform rather specific financial management oversight and operational responsibilities, including:

- Settlement of differences arising among agencies regarding implementation of financial management policies.
- Issuance of those policies and directives necessary to carry out the CFO Act.
- Provision for complete, reliable, and timely information to the President, Congress, and the public regarding management activities of the executive branch.
- Chairing of the new Chief Financial Officers Council, established by section 302 of the CFO Act.

Additionally, OMB was required to directly communicate with financial officers of states and local governments, and foster exchanges of information concerning financial management standards, techniques, and processes.

Congress, to correct perceived and existing Federal financial management deficiencies, made OMB responsible for specific responsibilities, such as these:

- Giving direction, leadership for, and establishment of financial management policies and requirements and for monitoring establishment and operation of Federal Government financial systems
- Reviewing agency requests for financial management systems and operations and advising on required resources to develop, effectively operate, and maintain and correct Federal financial management systems
- Establishing the general management policies for executive agencies and performing several general management functions relating to:
  - Managerial systems
  - Systematic measurement of performance
  - Procurement policy
  - Grants, cooperative agreements, and assistance management
  - Information and statistical policy
  - Property management
  - Human resource management
  - Regulatory affairs
- Conducting organizational studies, long-range planning, program evaluation, productivity improvement, and experimentation and demonstration programs
- Reviewing and recommending changes to budget and legislative proposals of Federal entities to ensure these organizations respond to program evaluations and are in accordance with general management plans

This guidance would be promulgated to Federal Agencies through OMB's Circular and Bulletin series.

### **Agency CFOs and Deputy CFOs**

The CFO Act of 1990 is unique among Federal law because it requires that the persons appointed to senior Federal financial management positions be competent and possess relevant experience. The act gave OMB other important responsibilities in this area. These included development and maintenance of qualification standards for agency CFOs and agency deputy CFOs appointed under the act and advising departments and agencies regarding selection of their CFOs and deputy CFOs.

The CFO Act (as amended) requires the appointment of a CFO in operating departments and agencies and some independent offices. Each Federal CFO is, for cabinet and larger agencies, appointed by the President and serves with the advice and consent of the Senate, or is designated by the President in consultation with agency heads. (CFOs of smaller agencies and offices are appointed by the head of the agency.) Congress

mandated that these executives be experienced and possess a certain level of competence, therefore requiring that the CFOs for both large and small Federal entities were to be appointed or designated:

from among individuals who possess demonstrated ability in general management of, knowledge of, and extensive practical experience in financial management practices in large governmental or business entities.

### **CFO Responsibilities**

The duties for department and agency CFOs included financial as well as nonfinancial roles, such as financial and nonfinancial systems, monitoring and accounting for budget execution, all aspects of all entity personnel having financial responsibilities, and certain department-wide reporting and budget-type responsibilities.

Prior to the enactment of the CFO Act, the financial management function was not, organizationally, at a uniform level across the Federal Government and responsibilities for financial management were dispersed among several senior executives. The average tenure of these executives was about 18 months—a term of service that produced constant turnover and was too short to permit these executives to effectively preside over projects that span fiscal years. The CFO Act requires that department and agency CFOs report to the head of the agency and the CFO is charged with overseeing all financial management activities relating to the programs and operations. Before the act the program and operational managers often had their own financial personnel reporting to them.

The responsibilities of agency CFOs and deputy CFOs were extended to include developing and maintaining integrated agency accounting, financial management systems, and personnel issues, including responsibilities to:

- Comply with applicable accounting principles, standards and requirements, and internal control standards.
- Comply with policies and requirements prescribed by OMB.
- Comply with other requirements applicable to systems.
- Provide for:
  - a. Complete, reliable, consistent, and timely information that is prepared on a uniform basis and that is responsive to the financial information needs of agency management.
  - b. The development and reporting of cost information.
  - c. The integration of accounting and budgeting information.
  - d. The systematic measurement of performance.
- Develop and support agency financial management budgets.
- Approve and manage agency financial management systems design and enhancement projects.

- Implement agency asset management systems, including systems for cash management, credit management, debt collection, and property and inventory management and control.
- Retain and financially support competent financial personnel to make recommendations to the agency head regarding the selection of the deputy CFO.

Until the CFO Act, the financial management function in Federal entities typically was split between the budgetary responsibilities and the fiscal accounting and reporting responsibilities, with the accounting officials having almost no role with respect to budget preparation or for budget execution. The act now requires that CFOs shall:

- Provide for the integration of accounting and budgeting information.
- Monitor the financial execution of the budget in relation to actual expenditures.
- Prepare and submit timely performance reports.
- Prepare and submit to the agency head and OMB an annual report that includes:
  - A description and analysis of the status of financial management of the agency.
  - Annual agency financial statements.
  - An annual audit report of the agency.
  - A summary of reports required under the FMFIA.

### **Federal Financial Statements: Agency and Government-Wide**

The CFO Act dictated that annual financial statements be prepared for each agency. These financial statements to be submitted to OMB must reflect the overall financial position, result of operations, and cash flows or changes in financial position of each revolving fund, trust fund, and the accounts of each office, bureau, and activity of a Federal entity performing substantial commercial functions during a preceding year. OMB was directed to prescribe the form and content of these agency financial statements. This guidance is promulgated through OMB circulars and bulletins.

### **Annual Independent Audits**

Annual independent audits of an agency's financial statements are another new financial management requirement of the CFO Act. (The other three areas are the (1) appointment of CFOs, (2) requirement to comply with applicable accounting standards and principles, and (3) publishing of financial statements by Federal departments and agencies.)

Section 304 of the CFO Act requires each financial statement to be prepared pursuant criteria cited in the act and to be independently audited in accordance with *Government Auditing Standards*. Where an agency has an IG, this audit is performed by the IG or an independent auditor, as determined by the IG. Where there is no IG, the head of the Federal entity determines the independent auditor to perform the audit.

The Comptroller General is authorized to review these audits or may perform the audit of the financial statements at the discretion of the Comptroller General or a



committee of Congress. The director of OMB periodically publishes guidance on the scope and other details of these audits in OMB circulars and bulletins.

### **CFO “Applicable Accounting Principles”**

Various sections of the act refer to “applicable” accounting principles and standards. For example:

- Section 301 requires that the five-year plans of the director of OMB, deputy director of OMB, and agency heads be consistent with “applicable accounting principles, standards, and requirements.”
- Section 303 states that the director of OMB shall prescribe the form and content of financial statements “consistent with applicable accounting principles, standards, and requirements.”
- Section 902 requires that agency CFOs comply with “applicable accounting principles, standards, and requirements, and internal control standards.”

In the CFO Act, Congress did not detail what these “applicable” financial criteria would be or designate which agency or Federal executive is responsible for determining the “applicable” financial criteria. But at the time the act was enacted, in 1990, the Comptroller General of the United States, Secretary of the Treasury, and director of OMB, by agreement, established the Federal Accounting Standards Advisory Board (FASAB, which is discussed in the following paragraphs.)

With the enactment of the CFO Act, the responsibility for setting accounting and financial reporting standards shifted from the GAO, in the legislative branch, to OMB, in the executive branch. Then in a 1990 agreement between GAO, OMB, and the Treasury Department, the FASAB was established to recommend the applicable accounting principles required by the CFO Act.

Over the decade of the 1990s, FASAB recommended several applicable accounting principles now regarded as the generally accepted accounting principles (GAAP) for each Federal Agency and the Federal Government as a whole. In 1999, FASAB was formally recognized by the American Institute of Certified Public Accountants as the sole and official standard setter of GAAP for Federal entities. In 1996, the Federal Financial Management Improvement Act (FFMIA) also compelled Federal entities to implement and maintain financial management systems that comply substantially with the “applicable” accounting standards.

### **The CFO Act: Other Changes**

The CFO Act required, among other mandates, that there be integrated agency accounting and financial management systems throughout the Federal Government. These integrated systems were to be designed to ensure compliance with internal control standards and the implementation of policies to provide consistency over data entry,

transaction processing and reporting and to also eliminate unnecessary duplication of transaction entries. *Integrated* agency accounting and financial management systems, including internal controls, were to be developed and maintained to ensure:

- Agency compliance with applicable accounting principles, standards and requirements, and internal control standards.
- Agency compliance with policies and procedures of OMB relative to accounting, auditing, reporting, and several other areas of financial management.
- Complete, reliable, consistent, and timely information is prepared on a uniform basis, responsive to the financial information needs of agency management.
- The integration of accounting and budgeting information by each agency.
- The systematic measurement of agency performance.

System requirements of the Federal Government now defined an *integrated agency accounting and financial management system* as a system that coordinates a number of previously unconnected functions in order to improve the overall efficiency and control. This system has four essential characteristics:

1. Standard data classifications for recording financial events
2. Common processing for similar transactions
3. Consistent control over data entry, transaction processing, and reporting
4. A system design that eliminates unnecessary duplication of transaction entry<sup>5</sup>

## **GOVERNMENT PERFORMANCE AND RESULTS ACT OF 1993, AMENDED IN 2010**

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### **Need for the Act**

Congress, in enacting the Government Performance and Results Act (GPRA), noted that Federal managers were seriously handicapped in their efforts to improve program efficiency and effectiveness because of an insufficient articulation of program goals and inadequate information on program performance. Also, congressional policy making, spending decisions, and program oversight were seriously handicapped by insufficient attention to agency program performance results.

The purposes detailed in the GPRA included:

- Initiation of program performance reform by requiring agencies to set program goals, measure program performance against those goals, and report publicly on progress.

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<sup>5</sup> See GAO report GAO-02-791T, "Effective Implementation of FFMIA is key to Providing Reliable, Useful, and Timely Data," June 2002.

- Improvement in Federal program effectiveness and public accountability by promoting a new focus on results, service quality, and customer satisfaction.
- Helping Federal managers improve service delivery by requiring that they plan to meet program objectives and by providing them with information about program results and service quality.
- Improvement in congressional decision making by providing more objective information on achieving statutory objectives, and on the relative effectiveness and efficiency of Federal programs and spending.
- Improvement in the internal management of the Federal Government.

### **Definitions: For Comparable Communications of Results**

To promote consistency and comparability in communicating program information and corresponding with Congress and the public, the GPRA provided the following definitions that were to be used throughout the Federal Government:

*Outcome measures.* An assessment of the results of a program activity compared to its intended purpose.

*Output measure.* The tabulation, calculation, or recording of an activity or effort expressed in a quantitative or qualitative manner.

*Performance goal.* A target level of performance expressed as a tangible measurable objective, against which factual achievement shall be compared, including a goal expressed as a quantitative standard, value, or rate.

*Performance indicator.* A particular value or characteristics used to measure output or outcome.

*Program evaluation.* An assessment, through objective measurement and systematic analysis, of the manner in, and the extent to which, an agency program achieves intended objectives.

## **FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT OF 1996**

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Among its findings when it enacted the FFMIA, Congress stated that:

- Federal accounting standards have not been uniformly implemented.
- Federal financial management continues to be seriously deficient.
- Federal financial systems and fiscal practices have failed to identify costs fully, reflect total liabilities of congressional actions, and accurately report the financial condition of the Federal Government.
- Continued use of these practices undermines the government's ability to provide credible and reliable financial data.

The FFMIA emphasized that control standards and systems of control had not been uniformly implemented by agencies relative to their Federal financial management

systems<sup>6</sup> but that these Federal financial management systems continued to be seriously deficient. FFMIA acknowledged that much effort had been devoted to Federal internal controls in past years and that uniform control standards still had not been implemented as part of an agency's *integrated* financial management system. More specifically, Congress declared that:

- Federal financial management continues to be seriously deficient because Federal financial management and fiscal practices have failed.
- Systems of controls have not been uniformly implemented and applied.
- Current accounting practices do not accurately report financial results of the Federal Government or full costs of programs and activities.

The intent of the FFMIA of 1996 was that Federal Agencies would:

- Implement the Federal Government's standard general ledger "at the transaction level."
- Eliminate past practices, such as manual cross-walks of data between accounts and systems.
- Cease reliance on work paper adjustments that might never be formally posted to the records.
- Discontinue the overreliance on cash accounting in lieu of the more complete accrual accounting recommended by the FASAB.
- Have Federal financial statements and reports routinely flow from the formal journal entries and ledger accounts that were a product of an effective system of internal controls.

The internal controls problem was compounded by systems growth over the years, with complexities resulting from increased automation and streamlining, continued decentralization and dispersion of program operations, and remote on-location, real-time accounting data inputted hundreds or thousands of miles from headquarters. Changes to agency systems environments, particularly the move to increasingly computerized databases, heightened the need to revamp existing Federal Agency controls where possible, but more than likely would require the design and implementation of entirely new controls.

In recent years, Federal Agency system failures and increased costs have resulted in increased scrutiny from OMB. Large enterprise-wide solutions have gone out of favor and are giving way to more focused and less costly incremental steps. Along with revisiting the way systems are implemented, OMB and the Treasury are taking a renewed look at FFMIA, its intent, and how compliance is measured. As part of this process, the hundreds

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<sup>6</sup> *Federal financial management systems* are defined to include internal financial controls, data, computer hardware, computer software, and competent and trained personnel.

of financial management systems requirements developed over the years by the Joint Financial Management Improvement program and later GSA's Financial Systems Integration Office (FISO) are being reviewed and revisited. In the past, these requirements and an accompanying certification process served as a seal of approval for Federal financial systems and were proxies for assessing FFMIA compliance. This front-end certification process has been eliminated and is in the process of being replaced with a back-end, more outcome-oriented FFMIA compliance assessment by both management and independent auditors. Over the years, FFMIA compliance has been much debated and subject to varying interpretations and will likely continue to be in the future.

### **FFMIA: Compliance Must Be Audited and Reported**

Congress, in the FFMIA, required each annual financial statement audit called for by the CFO Act of 1990 to comply with Section 803 of the FFMIA (31 USC 3512). This section mandated each Federal Agency to implement and maintain financial management systems that:

1. Comply substantially with Federal financial management systems requirements.
2. Comply substantially with applicable Federal accounting standards.
3. Comply substantially with the U.S. government Standard General Ledger at the transaction level.

Congress also required each of the required annual financial statement audits to specifically report on whether the agency financial management systems comply with the three requirements of the FFMIA. When an auditor finds that the agency's financial management systems do not comply with these three FFMIA requirements, Congress states the auditor shall identify in the audit report:

- The entity responsible for the financial management systems found to be in noncompliance.
- All the facts pertaining to the failure to comply with the three conditions of the FFMIA, including:
  - The nature and extent of noncompliance, including where there is substantial but not full compliance.
  - The primary reason or cause of noncompliance.
  - The entity or organization responsible for the noncompliance.
  - Any relevant comments from any responsible officer or employee.
  - A statement with respect to the recommended remedial actions and the time frames to implement such actions.

In 2001, OMB issued guidelines for assessing compliance with FFMIA to be used by both management and independent auditors. In an effort to standardize and improve financial management systems, the Joint Financial Management Improvement Program,

consisting of representatives from OMB, GAO, Treasury, and the GSA, developed financial management system standards and a certification process for financial systems to pass before being acceptable for Federal Agency use. The number and detail of financial system standards proliferated over the years, and in 2010, OMB disbanded FISO. These standards are part of the body of Federal financial management systems requirements in place today. However, efforts are currently under way to review these requirements and revisit the measures for determining compliance with the FFMIA.

### **ACCOUNTABILITY FOR TAX DOLLARS ACT OF 2002**

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The Accountability for Tax Dollars Act of 2002 extended the requirement for annual audited financial statements to executive agencies beyond those required to prepare and audit financial statements by the CFO Act. In doing this, the act extended financial accountability to many of the smaller entities within the executive branch not falling under a major Federal department or agency.

### **IMPROPER PAYMENT INFORMATION ACT OF 2002, AMENDED IN 2010 AND 2012**

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The issue of improper payments by the Federal Government was elevated to prominence by GAO in a series of targeted audits they performed. Congress responded with a series of legislative changes including the initial passage of the Improper Payment Information Act of 2002 and subsequent amendments in 2010 and 2012. These collective pieces of legislation require Federal Agencies to identify high-risk programs susceptible to improper payments, develop statistically based improper payment estimates, establish corrective action plans to address underlying causes, and track and report progress. In 2012, improper payments are estimated to be more than \$100 billion, centered mostly in the Medicare, Medicaid, Earned Income Tax Credit, and Unemployment Insurance programs.<sup>7</sup> Agency IGs are required to annually assess agency effort to comply with improper payments legislation.

### **DEPARTMENT OF HOMELAND SECURITY FINANCIAL ACCOUNTABILITY ACT OF 2004**

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The Department of Homeland Security Financial Accountability Act of 2004 extended many of the requirements of the CFO Act to this newly created Federal Agency. Most noteworthy from an audit standpoint is the requirement for audited financial statements as

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<sup>7</sup> According to [paymentaccuracy.gov](http://paymentaccuracy.gov), a White House Web site.

well as a separate audit opinion on internal control over financial reporting. While a number of Federal Agencies voluntarily pursue this separate audit opinion, only the Department of Homeland Security is required to have it by law.

### **FEDERAL FUNDING ACCOUNTABILITY AND TRANSPARENCY ACT OF 2006**

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The Federal Funding Accountability and Transparency Act of 2006 introduced a new level of financial reporting facilitated by advances in technology and the Internet. This legislation calls for Federal Agencies to report detailed spending information for grants and contracts on a government-sponsored Web site. This type of financial reporting has raised a number of issues, including the value of voluminous noninterpretive financial data, the quality and consistency of these detailed data as compared with audited information, and the need for independent assurance. These issues will continue to be debated as this type of detailed financial reporting proliferates on other government Web sites.





# 3 SELECTED ISSUES IN FEDERAL FINANCIAL AND INTERNAL CONTROL REPORTING

## FEDERAL FINANCIAL STATEMENTS

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Since the enactment of the Chief Financial Officers Act (CFO Act) and later laws, annual financial statements are now compiled department- and agency-wide and are independently audited. This section provides context for understanding Federal financial statements and discusses the implementation of this reporting requirement. It also discusses internal controls generally and specifically assessing internal control over financial reporting.

Since the Constitution was written, Congress has desired that sounder, more effective internal controls be designed, implemented, and used by Federal Agencies. Congress has held hearings, commissioned studies, and heard speeches and presentations before its committees about the importance of internal controls over financial reporting. Congress's attempts to address the historically weak and deteriorated controls of the Federal Government are unmistakable and based on the trail of laws addressing the installation and strengthening of controls.

In the single decade of the 1990s, a number of laws were enacted with respect to Federal financial management systems. With few exceptions, parts of each law emphasized the need for strengthened controls. But until 2002 and the Sarbanes-Oxley Act (SOX), no law required that any entity, in either the private or the public sector, have a management assessment and public reporting of internal controls over financial reporting and to also have an independent audit of those controls simultaneously with the audit of the entity's financial statement. In July 2002, Congress sent a clear, simple message to public corporations: "Assess internal controls over financial reporting; audit internal controls over financial reporting." Similarly, in December of 2004, the Office of Management and Budget (OMB) issued revisions to OMB Circular A-123, *Management's Responsibility for Internal Control*, subjecting Federal Agencies to similar requirements, but stopping short of requiring a separate audit opinion on internal control over financial reporting.

### **Federal Financial Reporting and Internal Control Today**

Federal accounting and reporting today have largely been defined by the CFO Act, Government Management Reform Act (GMRA), and related requirements contained in Federal generally accepted accounting principles (GAAP) issued by the Federal Accounting Standards Advisory Board (FASAB). Since the enactment of the CFO Act, agencies have focused on improving accounting disciplines and financial controls to the point where they can prepare financial statements and receive an unqualified opinion from an independent auditor on an accelerated reporting schedule. This has been no easy task. To varying degrees, the relative size and complexity of Federal Agencies along with the variety of nonintegrated financial-related systems that have arisen over many years have added to the challenge.

However, the annual focus on preparing and auditing financial statements has resulted in improvements in internal control and steady progress toward more reliable budgetary and financial information. A recent report developed by the Federal Chief Financial Officers Council found that:

[A]nnual preparation and audit of agency and Government-wide financial statements, have contributed to the evolution of reliable, timely, and useful financial information in the Federal Government.<sup>1</sup>

For fiscal year (FY) 2012, 21 of the 24 major Federal Agencies were able to achieve the milestone of an unqualified audit opinion. The results of all agency audits are reflected in Table 3.1.

### **Accelerated Audit and Reporting Schedule**

In 2005, the OMB required agencies to begin reporting their audited financial statements within 45 days after the end of the fiscal year. The accelerated reporting schedule has placed an increased emphasis on internal controls to produce reliable information. Prior to the accelerated reporting requirements, agencies took six months or more to produce audited financial statements. Accelerated financial reporting has transformed Federal accounting operations, financial reporting, and auditing within the Federal Government, elevating the importance of sound internal controls to produce reliable information from quarter to quarter.

For example, key reconciliations could no longer be delayed until the end of the year; there simply was not enough time. Internal controls needed to be improved to the point where reliable quarterly, and even monthly, information could be produced and audited in a timely fashion. The approach auditors took to auditing Federal financial statements also

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<sup>1</sup> Association of Government Accountants, *The Chief Financial Officers Act of 1990—20 Years Later*, July 2011.

**TABLE 3.1 Summary of FY 2012 Financial Statement Audit Results by Agency**

<i>CFO Act Agency</i>	<i>Audit Results</i>
Department of Agriculture	Unqualified
Department of Commerce	Unqualified
Department of Defense	Disclaimer
Department of Education	Unqualified
Department of Energy	Unqualified
Department of Health and Human Services	Unqualified
Department of Homeland Security	Qualified
Department of Housing and Urban Development	Unqualified
Department of Interior	Unqualified
Department of Labor	Unqualified
Department of Justice	Unqualified
Department of State	Unqualified
Department of Transportation	Unqualified
Department of Treasury	Unqualified
Department of Veterans Affairs	Unqualified
Agency for International Development	Qualified
Environmental Protection Agency	Unqualified
General Services Administration	Unqualified
National Aeronautics and Space Administration	Unqualified
National Science Foundation	Unqualified
Nuclear Regulatory Commission	Unqualified
Office of Personnel Management	Unqualified
Small Business Administration	Unqualified
Social Security Administration	Unqualified

*Source: 2012 Financial Report of the U.S. Government, Department of the Treasury, p. 5.*

shifted. Audits became more focused on internal controls to determine if they could be relied on to produce accurate financial statements. Purely substantive audits could not be successfully completed in the new accelerated timeline. Producing and auditing financial statements on an accelerated schedule are now routine for most Federal Agencies, representing a significant milestone in Federal financial management.

### **Assertions Relating to Internal Control over Financial Reporting**

Also contributing to the shape of the current landscape of Federal financial management is OMB Circular A-123, *Management's Responsibility for Internal Control, Appendix A, Internal Control over Financial Reporting* (Circular A-123, Appendix A), which became effective in 2006. OMB Circular A-123 serves as the implementing regulation for the Federal Managers' Financial Integrity Act (FMFIA). While it has existed since 1982 providing guidance on how Federal Agencies should assess and assert over internal controls, it has not specifically addressed internal control over financial reporting.

SOX, while not applicable to Federal entities, served as an impetus for revisions to Circular A-123 and the development of Circular A-123, Appendix A, requirements specifically related to assessing and reporting on internal control over financial reporting. OMB imposed control assessment and reporting responsibilities, similar to those contained in SOX, on the management of Federal departments and agencies with respect to Federal Agency financial controls. Specifically, it introduced the requirement that management must annually assess and assert to the effectiveness of internal control over financial reporting. Of note is one important difference between this circular and the SOX law: Circular A-123, Appendix A, does not require a separate audit of internal controls over financial reporting. This was determined to not be cost beneficial since Federal audits required internal control testing and reporting.

However, one agency, the Department of Homeland Security (DHS), is required by the DHS Financial Accountability Act to have a separate audit opinion on internal control over financial reporting. Other agencies, such as the Social Security Administration, have also routinely sought a separate audit opinion on internal controls but have done so voluntarily.

The effect of OMB Circular A-123, Appendix A, has been significant. It has raised awareness and understanding across the Federal Government in regard to the importance of financial reporting and internal controls. Major Federal Agencies now have in place a structured and consistent process that can be used to provide management with evidence to support its assertion over internal control.

OMB Circular A-123, Appendix A, has also served as an overarching requirement within which other financial management improvement efforts can be integrated and leveraged. For example, opportunities exist for independent financial statement auditors to leverage documentation and testing performed by A-123 assessment teams within Federal Agencies. This would be similar to the way corporate financial statement auditors utilize internal audit resources. Further, the process documentation and testing work performed as part of the A-123 assessment serve as leverage points for streamlining controls and for validating corrective actions. Similarly, the internal control assessment process can be used to conduct related assessments in targeted areas of concern, such as improper payments and detailed financial spending reports. This type of integration and efficiency has yet to be fully realized.

### **Internal Controls Standards**

In 1999, the Government Accountability Office (GAO) developed internal control standards for the Federal Government with the publication of what is informally known as the GAO Green Book. The GAO Green Book is based on the *Internal Control—Integrated Framework* developed by the Consortium of Sponsoring Organizations (COSO) of the Treadway Commission in 1992. These standards are incorporated by reference in OMB Circular A-123.

Since its release in 1992, COSO's *Internal Control—Integrated Framework* (or the *COSO Framework*) has become the controls standard for much of the business world. The COSO control concepts have been tested by many and applied in thousands of audits, and have also been adopted by numerous private and public sector organizations as their own controls framework. Efforts are currently underway to update the COSO Framework with an Exposure Draft issued in September 2012 and subsequently, the GAO Green Book.

In the *COSO Framework*,<sup>2</sup> *internal controls* are broadly defined as:

a process, effected by the governing board, management, and other personnel of an audited entity, that is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of controls in operations—relates to the entity's performance and financial goals and safeguarding of entity resources.
- Reliability of financial reporting—relates to the preparation of reliable published financial statements, including interim and condensed financial statements, and selected financial data extracted from such statements.
- Compliance with applicable laws and regulations—that relate to or apply to the audited entity.

### ***COSO Structural Components***

Under the COSO definition, *internal controls* encompass or consist of five interrelated structural components:

1. *Control environment*. The environment sets the tone of an organization, provides the discipline and structure, and is the foundation for all other components of internal control.
2. *Risk assessments*. Identification, analysis, and assessment of the relative risks to achievement of entity objectives.
3. *Control activities*. The policies, procedures, and practices that help ensure management directives are carried out, including a range of activities, such as: approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.
4. *Information and communication*. The information systems that produce reports containing operational, financial, and compliance-related information that make it possible to administer, control, and manage an organization's performance.

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<sup>2</sup> Based on a 1992 report by the Committee of Sponsoring Organizations, a consortium of cooperating organizations that includes the Financial Executives Institute, American Institute of Certified Public Accountants, American Accounting Association, Institute of Internal Auditors, and Institute of Management Accountants.

5. *Monitoring*. The periodic, regular monitoring of systems of internal controls to assess the controls systems performance over a period of time that includes regular management and supervisory activities and other actions personnel take in performing their duties.

With respect to information technology-related controls, COSO identified two types:

1. *General controls*. Controls over:
  - Data center operations (scheduling, backup, recovery procedures).
  - Systems software controls (acquisition and implementation of operating systems).
  - Access security.
  - Application system development and maintenance controls (acquisition and implementation of individual computer software applications).
2. *Application controls*. Controls designed to:
  - Control information processing.
  - Help ensure the completeness and accuracy of transaction processing, authorization, and validity, and effectiveness of interface of applications.

## **AN EMPHASIS ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

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In 2004, OMB issued revisions to OMB Circular A-123, emphasizing internal control over financial reporting. The revised circular required a separate management assurance statement on internal control over financial reporting and a separate Appendix A, with requirements for assessing financial control effectiveness. The Appendix A guidance was further supplemented in June of 2005 with specific “hands on” guidance for conducting assessments issued by the Federal CFO Council.

Similar to COSO, OMB in Circular, A-123 (2004), described two groupings of internal controls:

- Controls encompassing program, operational, and administrative areas as well as accounting and financial management, and should be an integral part of an agency’s entire cycle of planning, budgeting, management, accounting, and auditing. From this view, internal control “is an integral component of an organization’s management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.”
- Secondly, controls relating specifically to financial reporting (a subset of the above internal controls), intended to provide *effective internal control over financial reporting* and provide reasonable assurance that financial reporting misstatements,

asset losses, or noncompliance with applicable laws and regulations, material in relation to financial reports, would be prevented or detected. Financial reporting for this purpose encompasses the annual financial statements of an agency as well as other significant internal and external financial reporting. “Other significant internal and external financial reporting” would be any financial reporting that could have a material effect on significant spending, budgeting, or other financial decisions of an agency or that is used to determine compliance with laws and regulations by an agency.

### **INTERNAL CONTROLS: REPORTING BY FEDERAL AGENCIES**

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Today, Federal Agencies report on internal controls to the President, Congress, and the interested public in two principal formats:

1. Management assertion statements required to be included in either an Annual Performance and Accountability Report or the Agency Financial Report (in either case management is required to provide assurance over the effectiveness of internal control in meeting the objectives of the FMFIA and a separate assurance over internal control over financial reporting)
2. Annual independent auditors reports that include a report on internal control identifying the results of tests of an agency’s controls over financial reporting as part of the agency’s annual financial statements pursuant to *Government Auditing Standards*

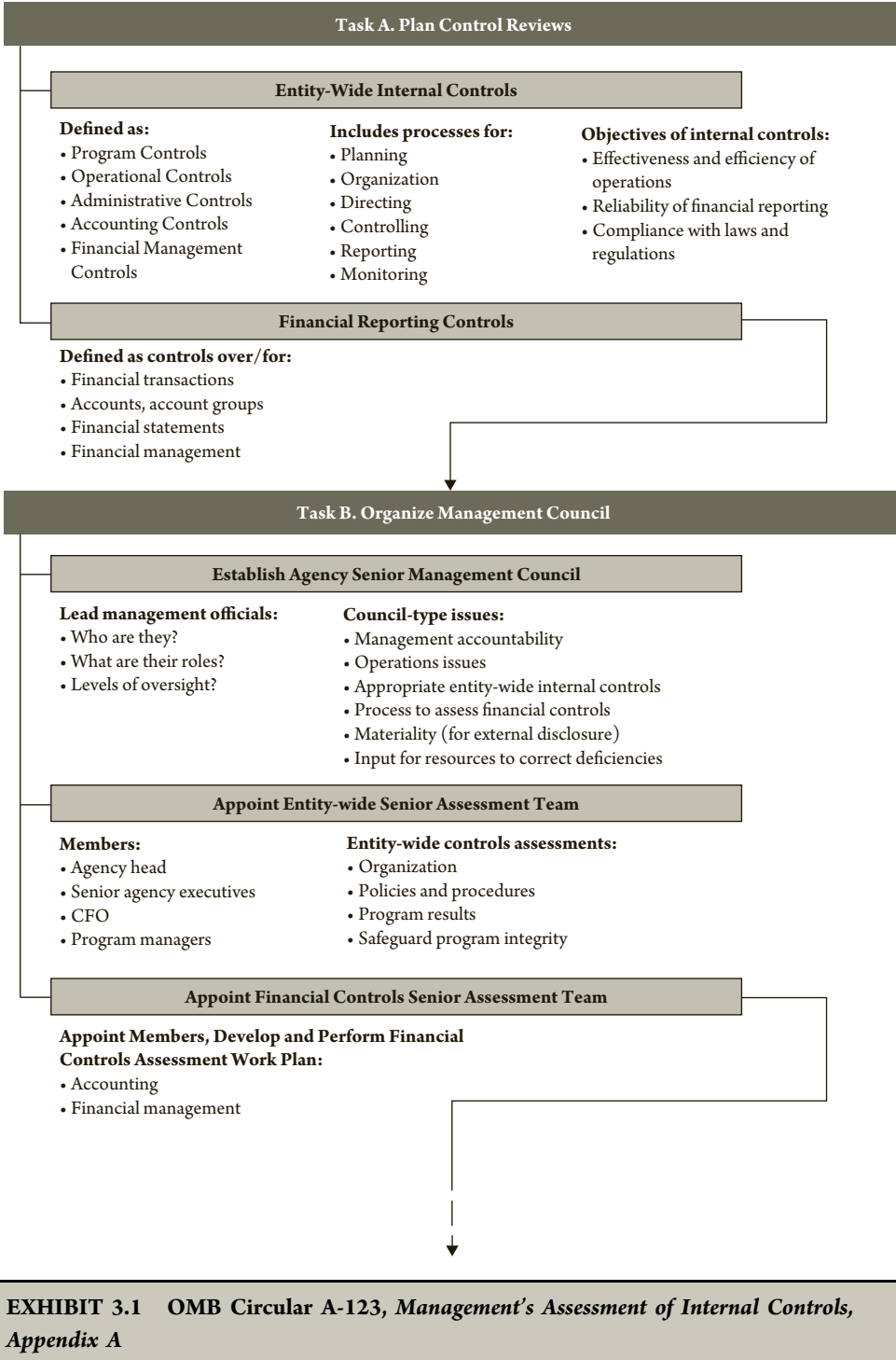
### **ASSESSING INTERNAL CONTROL OVER FINANCIAL REPORTING**

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The genesis of the Federal Government’s *Performance and Accountability Report* is Section 4 of the FMFIA of 1982, which requires an annual statement on whether the agency’s financial management systems conform to government-wide requirements presented in OMB Circular A-127, *Financial Management Systems*. OMB Circular A-123 is a consolidating policy statement blending financial management requirements of laws, earlier OMB regulations, positions of Federal Inspectors General (IGs), and guidance promulgated over the years by the GAO.

Exhibit 3.1 highlights several tasks required to assess and render an annual statement regarding the effectiveness of an agency’s internal controls to comply with OMB Circular A-123.

For *Performance and Accountability* reporting, the circular states that an agency’s entity-wide internal controls include an agency’s processes for planning, organizing, directing, controlling, and reporting on agency operations. The overall objectives include the effectiveness and efficiency of operations, reliability of financial reporting, and compliance







**Task C. Conduct Controls Assessment Tasks**

**Discuss/Compile Controls Review Criteria**

- |   |   |
|---|---|
| <p><b>Federal laws, as amended:</b></p> <ul style="list-style-type: none"> <li>• IG Act of 1978</li> <li>• FMFIA of 1982</li> <li>• CFO Act of 1990</li> <li>• GPRA of 1993</li> <li>• FFMA of 1996</li> <li>• Single Audit Act of 1996</li> <li>• FISMA of 2002</li> <li>• IPFA of 2002</li> </ul> | <p><b>Other guidance:</b></p> <ul style="list-style-type: none"> <li>• Agency controls policies</li> <li>• OMB Bulletin 01-02</li> <li>• OMB Circular A-123</li> <li>• Government Auditing Standards</li> <li>• AICPA Auditing Standards</li> </ul> |
|---|---|

**Know Agency Controls History**

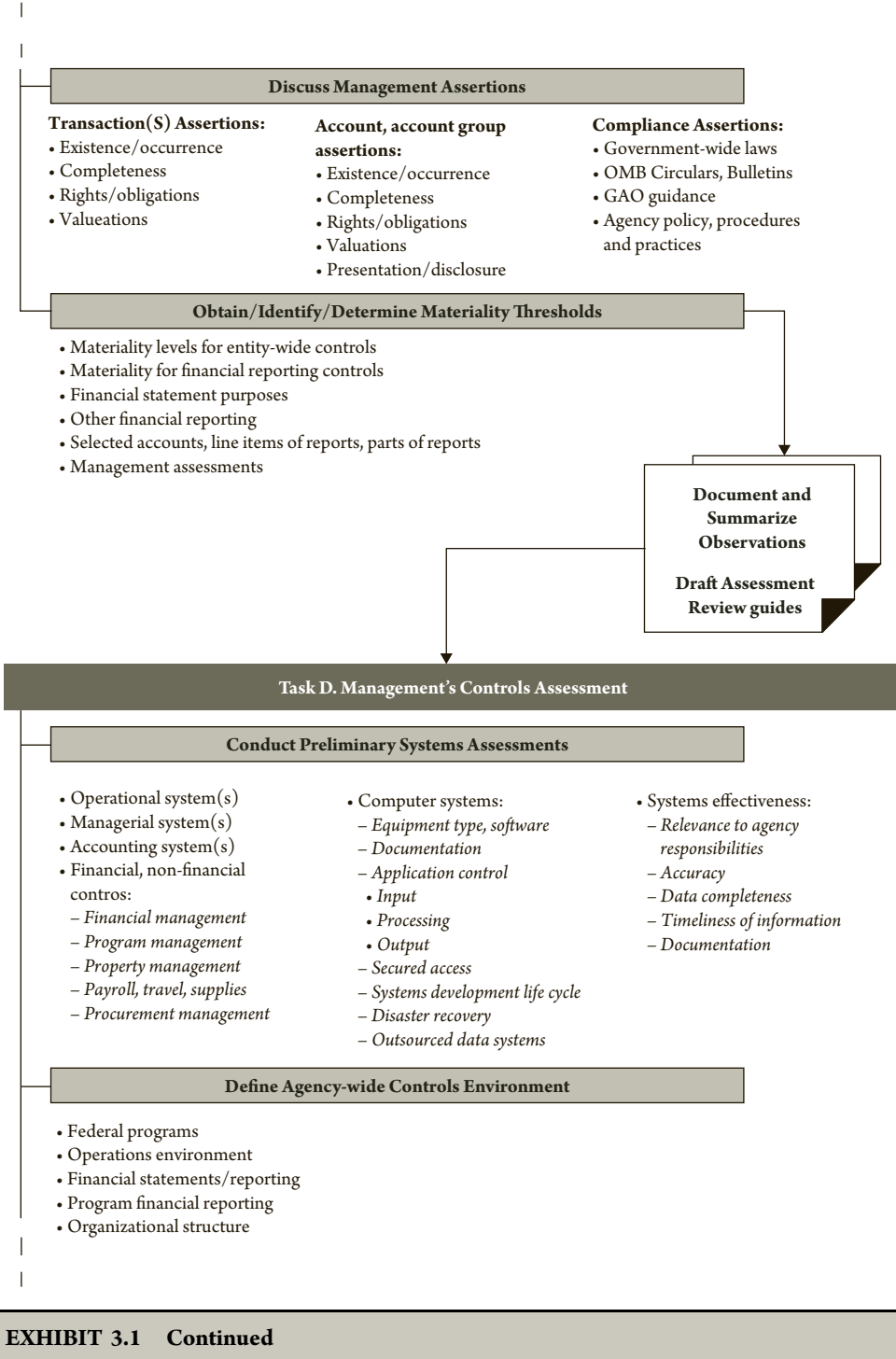
- |  |  |   |
|--|--|---|
| <ul style="list-style-type: none"> <li>• Past issues, problems?</li> <li>• Past IG</li> <li>• Financial and other audit reports</li> <li>• Consultant evaluations</li> </ul> | <p>• Identify past:</p> <ul style="list-style-type: none"> <li>– Reportable conditions</li> <li>– Material weaknesses</li> <li>– Significant deficiencies</li> </ul> | <ul style="list-style-type: none"> <li>• Results of earlier systems/controls survey:                         <ul style="list-style-type: none"> <li>– Internal surveys</li> <li>– External surveys</li> </ul> </li> </ul> |
|--|--|---|

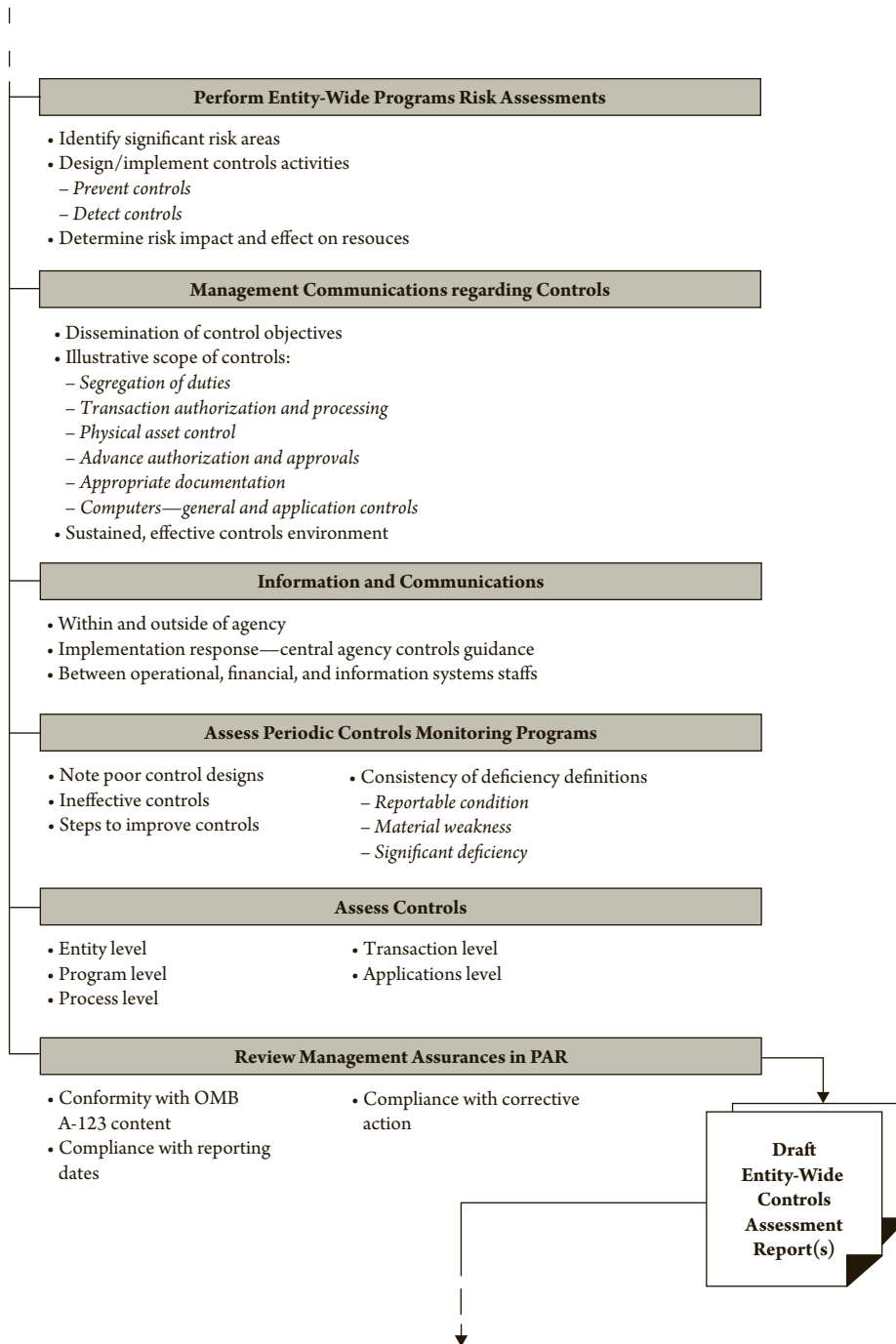
**Determine Control Assessment Objectives**

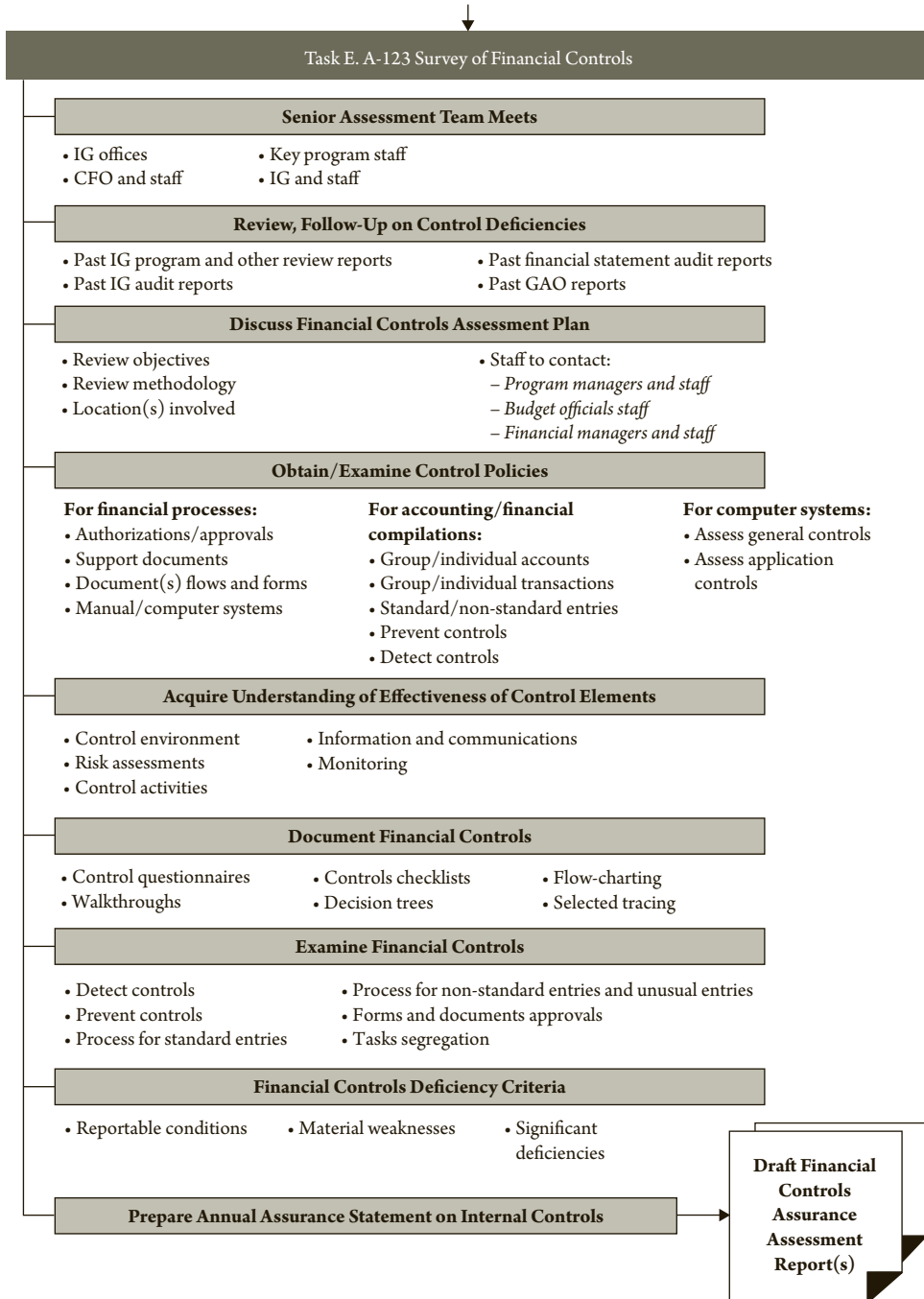
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|---|--|
| <ul style="list-style-type: none"> <li>• Do obligations and costs comply with laws and regulations?</li> <li>• Are assets/resources safeguarded?                         <ul style="list-style-type: none"> <li>– To avoid waste?</li> <li>– To contain losses?</li> <li>– To eliminate abuses?</li> </ul> </li> <li>• Are revenues and expenditures:                         <ul style="list-style-type: none"> <li>– Properly recorded?</li> <li>– Properly accounted for?</li> </ul> </li> <li>• Internal control objectives:                         <ul style="list-style-type: none"> <li>– In writing and in place?</li> <li>– Achieve effective and efficient operations?</li> <li>– Ensure reliability of financial reporting?</li> <li>– Promote compliance with laws and regulations?</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>• Are controls integral to entire cycles for:                         <ul style="list-style-type: none"> <li>– Planning?</li> <li>– Budgeting?</li> <li>– Management?</li> <li>– Accounting?</li> <li>– Auditing ?</li> </ul> </li> <li>• Do controls cover/apply to:                         <ul style="list-style-type: none"> <li>– Financial statements?</li> <li>– Internal financial reports?</li> <li>– External financial reports?</li> <li>– Budgetary reports?</li> <li>– Selected accounts? Line items of reports?</li> <li>– Parts of reports?</li> </ul> </li> </ul> |
|---|--|

**Document Process/Methodology**

- Communicating controls process and methods
- Applying internal controls standards:
  - Entry-wide
  - Over accounting and financial reporting







**EXHIBIT 3.1 Continued**

with applicable laws and regulations. The specific statutory guidance considered by OMB in its deliberations on Circular A-123 emanates from:

- *Federal Managers' Financial Integrity Act of 1982*. OMB, in consultation with the Comptroller General, established guidelines for evaluation by individual agencies of their own systems of accounting and administrative controls. The head of each agency was required to annually assess its systems for compliance with this guidance, make an annual determination concerning their controls, and report on this compliance with the FMFIA to the President and Congress. FMFIA stated that controls systems were to provide reasonable assurance that:
  1. Obligations and cost incurred and reported by Federal Agencies are in compliance with applicable law.
  2. Federal funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation.
  3. Revenues and expenditures applicable to a Federal Agency's operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.
- *Inspector General Act (IG Act; 1978)*. IGs and/or external auditors are required by the *Government Auditing Standards* and OMB Bulletin 01-02, *Audit Requirements of Federal Financial Statements*, to report material weaknesses in the internal control and noncompliance with laws and regulations as part of the annual financial statement audit.
- *Single Audit Act (1984)*. This act requires financial statement audits of non-Federal entities that receive or administer grant awards of Federal monies that include testing the effectiveness of the internal control and determining whether the award monies have been spent in compliance with laws and regulations.
- *Chief Financial Officers Act (CFO Act; 1990)*. Agencies are required to prepare annual financial statements and have those statements independently audited, at which time the auditors must, in compliance with *Government Auditing Standards*, report on the agency's internal controls and its compliance with laws and regulations.
- *Government Performance and Results Act (GPRA; 1993, as amended)*. This act requires agencies to develop strategic plans, set performance goals, and report annually on actual performance compared to goals. These plans and goals must be integrated into (1) the budget process, (2) the operational management of agencies and programs, and (3) accountability reporting to the public on performance results and on the integrity, efficiency, and effectiveness with which they are achieved.
- *Federal Financial Management Improvement Act (FFMIA; 1996)*. This act requires agencies to have financial management systems that substantially comply with Federal financial management systems requirements, accounting and financial

reporting standards promulgated by FASAB, and the U.S. Standard General Ledger “at the transaction level.” Agency heads shall make an annual determination about whether their financial management systems substantially comply with FFMIA.

- *Federal Information Security Management Act* (FISMA; 2002). This act requires agencies to provide a comprehensive framework for ensuring the effectiveness of information security controls over information resources that support Federal operations and assets and annually report on the effectiveness of the agencies’ security programs. Weaknesses found under FISMA categorized as “significant deficiencies” must also be reported as material weaknesses under FMFIA.
- *Improper Payments Improvement Act* (IPIA; 2002, as amended). Agencies are to review and “identify programs and activities that may be susceptible to significant improper payments” and annually submit estimates of improper payments, corrective actions to reduce the improper payments, and statements as to whether their current information systems and infrastructure can support the effort to reduce improper payments. The incidence of improper payments should be considered when assessing the effectiveness of the internal control.
- *Reports Consolidation Act* (2000). This act required consolidation of numerous performance, management, and accountability reports, mandated by many earlier laws, into one annual report, the *Performance and Accountability Report* (PAR), to be annually submitted by the head of a Federal Agency to the President, Congress, and the general public.

## OMB INTERNAL CONTROL DEFICIENCIES

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To comply with the previous statutes and OMB’s consolidating Circular A-123, agency managers must identify and report deficiencies in internal control. While materiality determinations may vary between audits and internal control assessments, the definitions of a control deficiency and material weakness are the same.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented or detected and corrected on a timely basis. At times, the applied definitions related to these circumstances have varied among Congress

(in its laws), OMB (in its circulars and bulletins relating to Federal audits), GAO (in its guidance and auditing standards), and the *COSO Framework*, which has been adopted by the Federal Government as guidance for its practices.

### **GAO'S GOVERNMENT AUDITING STANDARDS: NO AUDIT OF INTERNAL CONTROLS OVER FINANCIAL REPORTING**

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For years, numerous laws and several OMB circulars and bulletins have required audits involving Federal monies to be conducted in accordance with the *Government Auditing Standards*. However, these auditing standards, issued by GAO, do not require that a Federal Agency's internal controls be audited. Instead, these standards require only that the internal controls be tested by auditors of Federal financial statements and that the results of those tests be reported. Specifically, the fieldwork and reporting standards for financial audits for generally accepted auditing standards (GAAS) require:

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

This field work standard has been further refined by the American Institute of Certified Public Accountants' (AICPA) Statements on Auditing Standards (SAS), which direct certified public accountants (CPAs) to obtain an *understanding* of (1) the design of a client's internal control policies and procedures and (2) whether the control policies and procedures have been placed in operation. This *understanding* of the controls structure must be documented (e.g., internal control questionnaires, checklists, flowcharts, decision tables, memoranda) by the auditor.

The second and third government auditing report standards require:

1. When providing an opinion or a disclaimer on financial statements, auditors should include in their report on the financial statements either a:
  - a. Description of the scope of the auditors' testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements, and the results of those tests or an opinion, if sufficient work was performed
  - or
  - b. Reference to the separate report(s) containing that information. If auditors report separately, the opinion or disclaimer should contain a reference to the separate report containing this information and state that the separate report is an integral part of the audit and should be considered in assessing the results of the audit.

3. For financial audits, including audits of financial statements in which the auditor provides an opinion or disclaimer, auditors should report, as applicable to the objectives of the audit
  - a. Significant deficiencies and material weaknesses in internal control, as defined in AICPA standards
  - b. All instances of fraud and illegal acts unless clearly inconsequential
  - c. Significant violations of provisions of contracts or grant agreements and abuse

## EMERGING ISSUES

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As Federal financial management and auditing continues to evolve, issues, and challenges continue to emerge. All of the emerging issues discussed in this section are currently cast in the shadow of the Federal budget. Addressing the uncertainties surrounding the Federal budget is the most prominent financial management emerging issue. It is during these times that the value that disciplined financial management and auditing bring in the form of greater accountability, financial integrity, and credibility is even more important. Accurately accounting for and monitoring Federal spending, maintaining sound internal controls, developing useful information to ensure that funds are spent wisely, and maintaining regular independent auditing and oversight are important for promoting confidence in Federal Government finances. Other emerging issues are discussed next.

### **Achieving a Government-Wide Audit Opinion**

The most visible indicator of the foundation of internal controls and accounting disciplines in place today within the Federal Government is the number of agencies with both an unqualified audit opinion and no material internal control weaknesses reported by their independent auditors. Achieving this goal on a government-wide basis is a sign of the financial integrity and credibility of the U.S. government.

At the agency level, achieving this goal requires incremental improvements in financial management operations and a sustained multiyear commitment by agency management and their auditors. Where success has been achieved, management and auditors have worked collaboratively year to year to resolve issues and improve accounting processes and internal controls.

Today, challenges still remain in some agencies to achieve auditable financial statements. The Department of Defense (DOD) has an annual budget of more than \$600 billion, more than 3 million civilian and military personnel, and worldwide operations. Its sheer size, complexity, and number of nonintegrated systems processing financial-related information make achieving auditability within the DOD challenging. The National Defense Authorization Act of 2010 has set a requirement for the DOD to be auditable by 2017; recently DOD leadership has accelerated this goal for certain financial statements.



Other large agencies face similar challenges; for example, DHS has the added complexity of being a relatively new Federal Agency that has merged, acquired, and started up new operations. Achieving the milestone of an unqualified audit opinion for DHS and other similar agencies will pave the way for an audit opinion on the financial statements of the U.S. government.

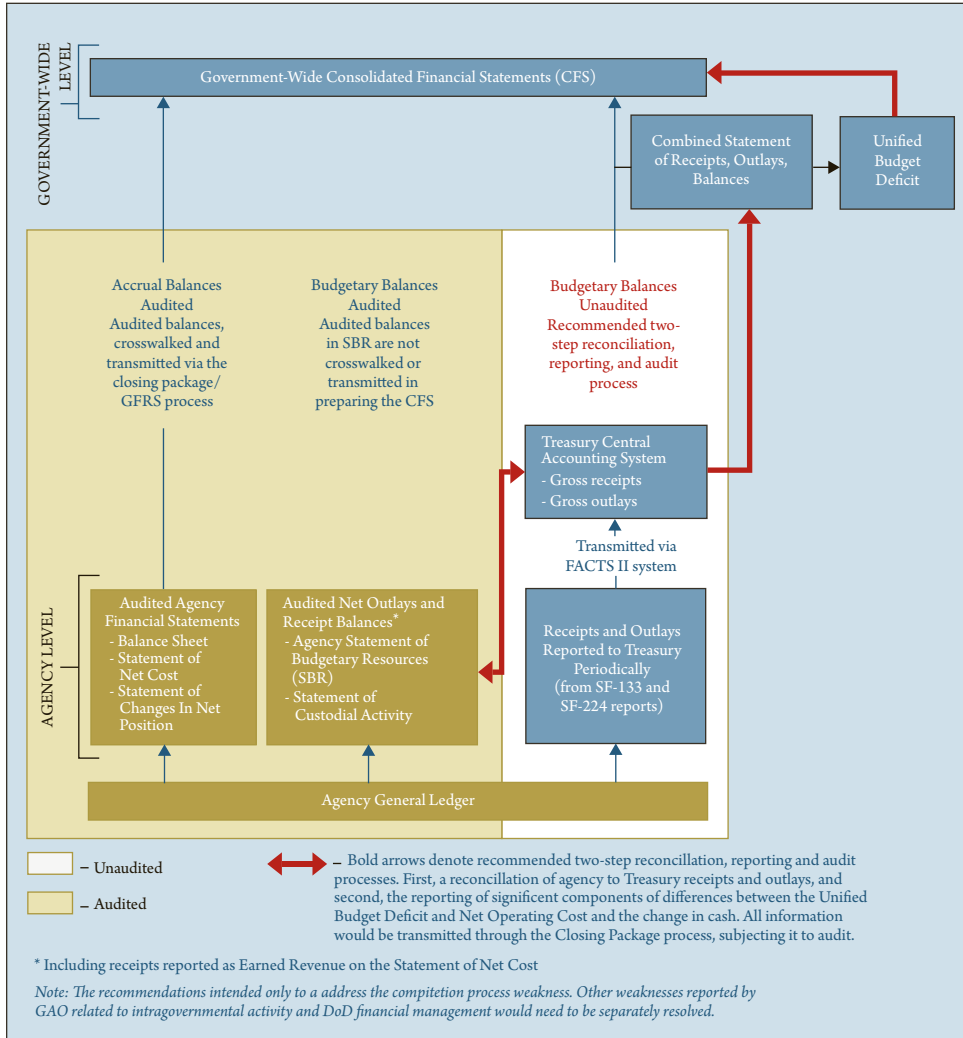
In addition, Treasury is focusing on the compilation process itself. Since 1997, material weaknesses over its compilation process have been reported by GAO, its independent financial auditor. Resolving this weakness entails correcting flaws in the flow and design of information gathered in support of the government-wide statements, mainly budgetary information accounted for in separate general ledger accounts at the Treasury and reported and audited at an aggregate level in agency financial statements. In a recent research report on the topic prepared by the Association of Government Accountants (AGA), the problem was described in these words:

Over the past 15 years, much time and effort have been placed on improving the quality of financial information reported in both agency financial statements and the CFS [consolidated financial statement]. It is fair to say that the majority of the focus to date has been on the accrual basis accounts within an agency. Only one of an agency's financial statements—the Statement of Budgetary Resources (SBR)—is derived solely from an agency's budgetary accounts, which are primarily on a cash basis. Information reported in the SBR is aggregated at the agency level, and final audited numbers are not reported further to or used by Treasury. Arguably, budgetary information is the most useful financial information within an agency, yet the lack of a transparent reconciliation process between agency and Government-wide balances has had the effect of inhibiting the audit of probably the most quoted and used number published by the Federal Government—the Unified Budget Deficit.

Exhibit 3.2 illustrates the audited and unaudited data flows supporting the government-wide financial report or CFS. Solving the internal control weakness in the compilation process will entail developing a process to compile and audit the unaudited flow. This flow consists of primarily budgetary information and reconciling items linking budgetary and accrual information reported. Adding transparency and the credibility of an independent audit assurance to this flow of information will add greater integrity to the CFS and other financial information reported by the Federal Government.

### **Developing Information to Support Decision Making**

Fully accomplishing the intent of the CFO Act entails evolving Federal financial management beyond a compliance-focused activity to a more value-added program where decision-useful information is routinely developed. Most agencies have achieved the first step toward this goal: having established a foundation of accounting disciplines and internal



AGA CORPORATE PARTNER ADVISORY GROUP RESEARCH

**EXHIBIT 3.2 Data Flows Supporting Government-Wide CFS**

controls that routinely produce reliable financial statements. The next step is to leverage the foundation to generate information to better meet the needs of agency leadership and program managers to support budget and program management decisions.

To this end, program cost information is noticeably absent from Federal financial management. The development of reliable cost information has been largely centered in agencies where a separate statutory requirement exists or where the agency operates an

internal service type fund where fees need to cover the full cost of operations. This pattern continues to hold true today, with only limited areas where cost information is being developed and used. The pressure for this type of information is increasing as the Federal budget tightens. Clear and consistently reported cost and performance information can inform better budget and program decision-making, rather than often used arbitrary, across-the-board approaches where efficient and high performing programs are treated the same as inefficient non-performing programs. Understanding program costs and the relationship of these costs to performance results is essential to achieving the ultimate goals of the CFO Act and to monitoring operational efficiency.

### **Leveraging Technology to Audit More Effectively**

In 2009, the American Recovery and Reinvestment Act (Recovery Act) became law with the intent to stimulate the nation's economy. The Recovery Act provided \$787 billion, most of which to be spent over a two-year period. To oversee the spending of these funds, a special Recovery and Transparency Oversight Board (RATB) was established to work closely with the Vice President, agency IGs, and the GAO. In implementing the Recovery Act, a number of practices emerged that could potentially shape the future of Federal financial management. According to the AGA Research Report titled *Redefining Accountability: Recovery Act Practices and Opportunities*:

In implementing the American Recovery and Reinvestment Act of 2009 [Recovery Act], Federal Agencies have introduced more aggressive risk management, strengthened oversight, incorporated more detailed financial reporting, and implemented other practices to enhance transparency and accountability over Government financial management . . . . [T]hese practices are innovative—and in some cases unprecedented—and have the potential to shape future Government financial management and reporting.<sup>3</sup>

Advances in technology along with greater sharing of information helped management and auditors meet these challenges. Comprehensive risk assessments were performed to pinpoint trouble areas, sometimes before a financial transaction occurred. One of the best examples of this is within the RATB operations, where the RATB utilized enhanced data mining, management, and sharing techniques to identify high-risk indicators and patterns. Other early-warning assessments, sometimes referred to as *flash reports*, were issued by agency IGs in an effort to shift their oversight forward to assist in the early identification of risk, supplementing a more traditional after-the-fact audit approach.

Similar risk-based, prevention-oriented approaches are being assessed to reduce Federal improper payments, estimated to be in excess of \$100 billion government-wide for

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<sup>3</sup> AGA Research Report, *Redefining Accountability: Recovery Act Practices and Opportunities*, July 2010, p. 4.

FY 2012.<sup>4</sup> (The practice of leveraging technology to more proactively address program and financial risk areas is an approach being used more and more in the Federal audit community to prevent fraud, waste, and abuse.)

### **Enhancing Financial Reporting**

Today, the realm of Federal financial information publicly reported is broad. It ranges from detailed transaction-level information reported on multiple government-sponsored Web sites to audited financial statements. As access to information becomes easier, reporting financial information meeting user needs becomes more challenging. Public satisfaction with government financial management information continues to be low. According to an AGA survey titled *Public Attitudes toward Government Accountability and Transparency* conducted in February 2010, the majority of those surveyed were not very satisfied or not at all satisfied with Federal financial management information reported. In addition, Congress frequently requests financial information arrayed in ways specific to meet its immediate needs.

Challenges exist in addressing the variety of user needs while balancing costs and benefits and maintaining consistency and integrity of the information being reported. Addressing this challenge will entail leveraging new technologies to improve access and understanding, while maintaining the internal control, data quality, and credibility benefits that are the hallmarks of the audited financial statement process.

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<sup>4</sup> Office of Management and Budget, Memorandum M 11-16, April 14, 2011.

## **PART II**

# **FEDERAL BUDGETING, ACCOUNTING, AND FINANCIAL STATEMENTS**



# 4 ACCOUNTING IN THE FEDERAL GOVERNMENT

## ***Budgets, Accountable Events, Transactions***

### THE FEDERAL BUDGET PROCESS

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While referred to as a singular, finite event, budgeting in the Federal Government is not a once-a-year undertaking. Work on the Federal budget never ceases. In practice, a department or agency is never addressing just a single budget phase or a single fiscal year. At the same time a current year's funding is being executed and accounted for, budget proposals for the next fiscal year are being vigorously defended before congressional committees. Concurrently, agency executives are discussing with Office of Management and Budget (OMB) the proposed budgets for the second-out fiscal year. In addition, financial personnel are concerned with applying the appropriate accounting and reporting to expired or "old" appropriations in years prior to the current year.

#### **Budget, Planning Years**

The focus of the news media, committees of Congress, the President, and the public is most often concentrated on a single fiscal year: the next one. However, the compilation of Federal budget estimates requires a multiyear perspective. The number of years that must be considered in structuring the budget estimates for just one fiscal year could include as many as eight, and possibly more, years.

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<i>Budget Indicator</i>	<i>Period or Year Referred to</i>
PY - 1: prior year - 1	Fiscal year immediately preceding the prior year
PY: prior year	Fiscal year immediately preceding the current year; the last completed fiscal year
CY: current year	Fiscal year the entity is in (October 1–September 30)
BY: budget year	Next fiscal year for which estimates are submitted to Congress
BY + 1: budget year + 1	Fiscal year following the budget year
BY + 2: budget year + 2	Second fiscal year following the budget year
BY + 3: budget year + 3	Third fiscal year following the budget year
BY + 4: budget year + 4	Fourth fiscal year following the budget year

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For the Federal Government, a congressional appropriation is the defining event from an accounting viewpoint—formally recording the appropriation is the first entry of a fiscal year, in Federal accounting. The accounting for budget execution, must, by law, cover the current fiscal year and the two fiscal years after the expiration of the appropriation. Then any remaining obligated balances of an appropriation are transferred to the expired or merged (“M”) accounts in the Treasury Department, where such balances remain available for several years to meet claims that might be submitted against earlier valid obligations.

## BUDGET CYCLE

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The Federal budget cycle might better be viewed as a never-ending process rather than a cycle, which implies an event with a distinct beginning and end. In practice, the cycle consists of several phases, not always clearly distinguishable, but always present:

Phase I: Budget preparation

Phase II: Congressional action

Phase III: Budget execution

Phase IV: Review and audit

### **Phase I: Budget Preparation Phase**

The *budget preparation phase* begins 15 to 18 months (or more) before the start of the fiscal year to which it will apply. This phase is a period of continuous exchange of information and decision making by the President, assisted by OMB and heads of individual departments, agencies, and special advisors.

### ***Partial Budgeting Prohibited***

Federal departments and agencies are prohibited by law and OMB regulations from deliberately minimizing budget requests by submitting estimates for partial or less than full funding of anticipated programs. For example, requests for major procurement programs must provide, by the years involved, for the entire cost of the program (with certain exceptions, such as reclamation, rivers and harbors, and flood control projects).

There is an exception to this partial funding prohibition. Although OMB budget guidance requires that departmental and agency budget requests include the effect of inflation, the budget estimates will not necessarily include an allowance for the *full* rate of anticipated inflation (OMB emphasis in its Circular A-11, *Preparation and Submission of Budget Estimates*). As an example, for discretionary programs, approved departmental totals may include an allowance for less than the full rate of anticipated inflation or even no allowance for inflation, as determined by OMB. Often these deliberate underestimates for inflation are extensively and heatedly discussed in Congress and are the subject of much



coverage by the news media. Approved agency totals may reflect the full inflation rate where such an allowance is required by law and a decision is made by OMB not to propose an inflation rate less than is required.

### ***Confidential Information***

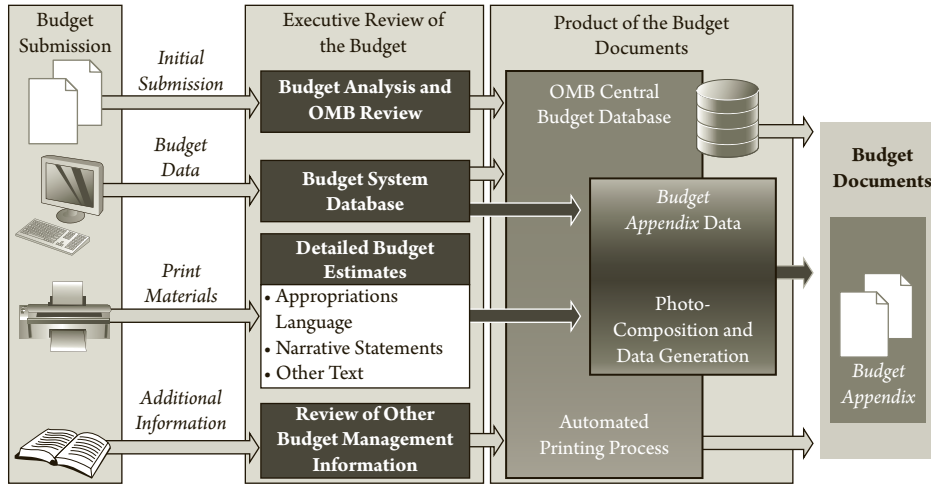
Budget information compiled or considered by the executive branch has historically been viewed as privileged information of the executive branch of government. A specific regulation (OMB Circular A-11) sets executive branch policy with respect to disclosure of budget preparation data. By the Budget and Accounting Act of 1921, the President is required to submit an annual budget request to Congress. This same law prohibits an agency submission to Congress in any other manner, unless at the formal request of either house of Congress.

OMB Circular A-11 emphasizes that the executive branch communications that led to the preparation of the executive branch budget request are not to be disclosed by agencies or by those who prepared the budget request. Maintaining the confidential nature of agency submissions, requests, recommendations, support materials, and similar communications is important because these documents are an integral part of the decision-making process by which the President resolves budget issues and develops recommendations for Congress. Budget decisions are not final until the President submits his or her budget request to Congress. Thus, until released by the President, information relating to the executive branch's proposed budget is considered *executive privileged*.

### ***OMB and CBO Roles***

In the budget preparation phase, iterations of views and exchanges of information transpire between various departments and agencies and OMB, beginning with the submission of an agency's initial budget requests. As the budget takes shape, and after the initial discussions and formal *pass back* of OMB budget and policy decisions, agencies provide revised budget data, consistent with presidential guidelines. These budget data are captured in a computer system used to collect and compile the final budget request submitted by the President to Congress.

The Congressional Budget Office (CBO), an agency in the legislative branch, responsible to Congress, has no role in preparing the proposed budget and issues no regulations or guidance concerning the budget process to any executive branch organization. CBO and OMB must cooperatively calculate Federal deficit estimates and measure compliance with congressional budget targets as congressional committees proceed through the budget deliberation process. CBO calculations must use the scorekeeping conventions of House and Senate budget committees. Monitoring by CBO is necessary to assess compliance with congressional budget targets and budget agreements between the executive and legislative branches. In contrast, OMB, an entity in the Executive Office of



**EXHIBIT 4.1 Overview of the Budget Process**

the President, has extensive control and monitoring responsibilities for preparing and executing Federal budgets. Exhibit 4.1 illustrates the congressional and executive branch budget process adhered to by the Federal Government.

OMB annually issues guidance to executive branch departments and agencies relating to the preparation and submission of budget estimates.<sup>1</sup> OMB guidance is both government-wide and agency-specific, including details such as formats, tables, schedule contents, definitions, and codes that must be used in submitting the department and agency final budget estimates to OMB. The guidance for individual departments and agencies generally relates to subjects such as ceilings and limitations (dollars, personnel, other resources, geographic operations, program levels, etc.), restrictions, new or revised policy direction, and so on. The issuance of this guidance is followed by innumerable meetings between OMB and department and agency executive management. On occasion, heads of Federal organizations who disagree with particular actions of OMB make direct appeals to the President. It is rare, though, that OMB guidance is at odds with presidential intent.

### ***Support for Department Proposals***

Agency budget requests are the output of a comprehensive financial system that integrates analyses, planning, evaluation, budgeting, accounting, and reporting. Budget

<sup>1</sup> For decades, the primary source of detailed budget guidance has been promulgated by OMB through Circular A-11. Definitions in this chapter relating to budget preparation and execution appear in this circular.

estimates ultimately sent to Congress reflect OMB and presidential views on the scope, content, and quality of Federal Agencies and all programs and activities for which the agency is responsible. For example, the budget request of a single agency must consider the roles; support responsibilities; and costs to state and local governments, academic institutions, nonprofit organizations, and even foreign governments. These budget requests will be compiled in a variety of funding formats. Congress could provide financing for a Federal Agency's operations through any or a combination of these methods, among others:

- Direct appropriation
- Contract authority
- Loans
- Loan guarantees
- Grants
- Contracts
- Formula entitlement-type financing

Budget preparation requires Federal entities to develop considerable demographic and economic data that, depending on the nature of the program, could also entail aggregation of information for over 400 congressional districts; 3,000 counties; and over 50,000 cities, municipalities, towns, townships, other special units of government; and hundreds of thousands of nonprofit, academic, and corporate organizations. All of this information must be compiled in a manner that permits its examination and evaluation by OMB and Congress in an expeditious manner.

### ***Nature of Agency Budget Requests***

OMB budget preparation guidance requires agencies to segregate budget requests by the nature of the estimate (e.g., regular, supplemental, or multiyear funding requests). The regular annual budget estimates must reflect all financial requirements anticipated at the time of budget submission by several categories, for example:

- *Continuing activities*, including those for which additional authorizing legislation is required for the budget year
- Authorized activities that are to be *proposed activities* for the budget year
- Amounts needed to meet *other specific financial liabilities* of activities imposed by law

No supplemental estimates or upward adjustments of past years' funding levels can be submitted by departments unless these adjustments are for circumstances that were unforeseen or due to subsequent action by Congress.

### **Phase II: Congressional Action Phase**

Congress can approve, change, disapprove, or ignore the President's proposed budget. The congressional action phase generally consists of two sets of hearings: (1) hearings for

authorization or continuation of a Federal program or activity; and (2) hearings for funding or approval of an appropriation, or other funding, of a program or activity. These phases are often comprised of several activities involving interested parties and, at times, even foreign countries:

- OMB and the agency representatives generally appear before committees of Congress to defend, explain, and justify the need for the proposed programs and the level of dollars requested.
- Congress may hold hearings attended by citizens, state and local governments, companies, nonprofit organizations, the general public, and even foreign governments to support or oppose particular programs or levels of requested financing.
- Special reviews and studies could be made and submitted to Congress, and Congress itself will authorize independent reviews to provide data that are valuable in reaching conclusions on various budget requests. CBO is a valuable contributor to these efforts.
- Executive sessions and private meetings are held among members and committees of Congress and persons and organizations involved or interested in particular programs.
- Continual release of budget information is made to the public media relating to suggested alternatives, program options, possible tax consequences, and the effect on projected debt ceilings of various programs. The purpose of such publicity is generation of interest, support, or opposition to competing positions on these programs. Sooner or later, Congress, through its committees, must develop legislated financial plans for the authorization and appropriation bills proposed, debated, changed, and then voted upon by Congress.

Once congressional consensus is reached, the various appropriations are submitted to the President for review and approval or veto. Note that the submissions are not made to the President as a single package but rather in the form of several appropriation laws.

Congressional approval of a program, with permission to obligate the Federal Government and spend Federal monies, is referred to as an *appropriation* (i.e., the legal or budget authority that makes funds available to individual departments and agencies for spending). The appropriation may be a *single-year appropriation* or a *several-year appropriation*. In some cases, the congressional budget authority may be a permanent budget authority, in which case funds become annually available to an agency without further congressional action.

On occasion, Congress will not complete action on all budget requests before the beginning of a fiscal year. In such circumstances, Congress may enact a *continuing resolution* (CR), a temporary financing authority for an agency to continue operations usually, but not always, until an appropriation is approved. While under a CR, the Federal entity must conform to certain fiscal restraints specified in the CR. These restraints typically include those listed next.

- The Federal Agency may not undertake any new initiatives.
- The Federal Agency must maintain its rate of expenditure at the same level of the preceding program year.
- If one house of Congress has acted on an agency's budget request, then the Federal Agency may not exceed the expenditure rate of that action or the expenditure rate of the last year's appropriation, whichever is less.

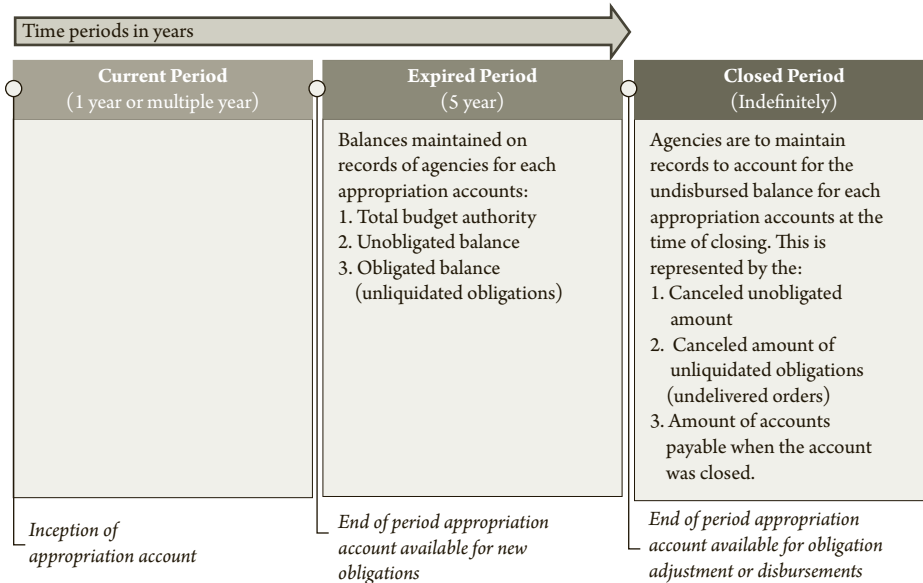
### **Phase III: Budget Execution Phase**

An agency's accounting during the budget execution phase is directly related to the status of appropriations for which it is responsible. Examples of status include whether the appropriation is unexpired and still active or whether the appropriation is expired and inactive.

#### ***Active, Unexpired Appropriations***

Once passed by Congress and approved by the President, appropriations and other approved budget authority, in combination, become the financial operating plan for the Federal Government for a fiscal year. Within departments and agencies, several activities must occur:

- At each department and agency, there must exist a system of accounting and financial controls for apportioning appropriated funds throughout the year to ensure that legislated goals and objectives are achieved and that budget deficiencies do not result.
- The specific appropriation(s) (i.e., there is usually more than one appropriation for which an agency is responsible) or other budget authority approved by Congress becomes the financial budget and operating plan for an agency. Activities financed by these appropriations must be monitored, controlled, and tracked to ensure full compliance with the intents of Congress.
- Accounting for the execution of a Federal entity's budget will span several fiscal years:
  - The initial accounting entry to formally record appropriation(s) is prepared by each responsible Federal entity after the Treasury Department and OMB establish an account number for that appropriation or other budget authority. This will be done at the outset of a fiscal year.
  - A current accounting is maintained by all Federal entities responsible for an appropriation(s) throughout the active or unexpired years of an appropriation(s) or budget authority.
  - Once an appropriation has expired, a detailed accounting and reporting is required for legally incurred obligations and expenditures for two fiscal years after the fiscal year in which the appropriation expired.



**EXHIBIT 4.2 Illustration of Appropriation Account Closing for Fixed-Period Appropriations**

***Expired, Inactive Appropriations***

Balances of expired appropriations are available to pay valid outstanding obligations at the time of expiration (i.e., undelivered goods) up to five years unless lengthened by legislation. Federal entities are not allowed to incur new obligations against expired budget authority but can make adjustments if the cost incurred is more than originally estimated. In comparison to the typical one-year accounting for a corporate entity, Federal Agencies are legally required to maintain formal accounts and make reports for each appropriation or budget authority for a period that could span five or more years.

This accountable time span is illustrated in Exhibit 4.2.

***Entity Controls***

The head of each Federal department and agency must, by law, establish and maintain systems of accounting and internal controls to provide reliable accounting for the activities of that Federal establishment. These systems are the basis for preparing and supporting the budget request of the Federal establishment. Additionally, the agency systems must provide accurate financial information for reporting externally to Congress, the President, OMB,

and the Department of Treasury, and for internal agency needs related to managing, controlling, and reporting on current operations. Agency systems of accounting and controls must provide accurate and timely information on actual obligations, outlays, unexpended and expended budgetary fund balances, and other resources. Agency internal controls must be established to ensure that conditions, restrictions, limitations, and other provisions of the appropriation or other laws are continually and consistently met and that the assets, investments, and other resources of the Federal Government are constantly safeguarded.

### ***Antideficiency Act***

The Antideficiency Act mandates the head of each agency prescribe, by regulation, a system for the administrative control of funds. This system of control, which cannot be inconsistent with any budgeting requirements or prescribed accounting procedures, must be designed to:

- Restrict both obligations and expenditures from each appropriation or fund account to the lower amount apportioned by OMB or to the amount available for obligations or expenditures in the appropriation or fund account.
- Enable the agency head to identify the person responsible for any obligation or expenditure exceeding the amount available in the appropriation or fund account, the OMB apportionment or reapportionment, the allotment or suballotments made by the agency, any statutory limitations, and any other administrative subdivision of funds made by the agency.

### ***Budgeting Concepts***

The Federal Government has made various attempts to achieve more precision in estimating required resources, in monitoring the expenditure rate of budgeted funds, and in determining the cumulative costs of agency programs. These efforts are dictated by concerns over the efficiency and effectiveness with which budgeted funds are being utilized and whether the objectives that Congress noted in laws are being attained, and in an economical manner. Not to be overlooked, though, is the fact that the budget is a statutory directive, violations of which must be reported to the President and Congress.

## **PPBS, ZBB, AND MBO BUDGET CONCEPTS**

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Three budgeting or planning concepts have been applied at various times by the Federal Government in an attempt to better manage Federal monies. Still in use, but more popular in the 1960s, is the planning, programming, and budgeting system (PPBS). At times, some Federal organizations have found merit in attempting to apply zero-based

budgeting (ZBB) and management by objectives (MBO) to Federal activities. Departments and agencies, however, were formally relieved of compiling budget requests in the ZBB format in 1981 when OMB rescinded this requirement ending the use of ZBB in the Federal Government. In the 1980s, some Federal Agencies took advantage of an option and were relieved of the responsibility to compile, defend, execute, account, and report their financial requests and activities under the PPBS concept. Fifty years later, though, PPBS continues to be the principal financial management and control process of the Department of Defense (DoD), Department of Homeland Security (DHS), and the National Aeronautics and Space Administration (NASA).

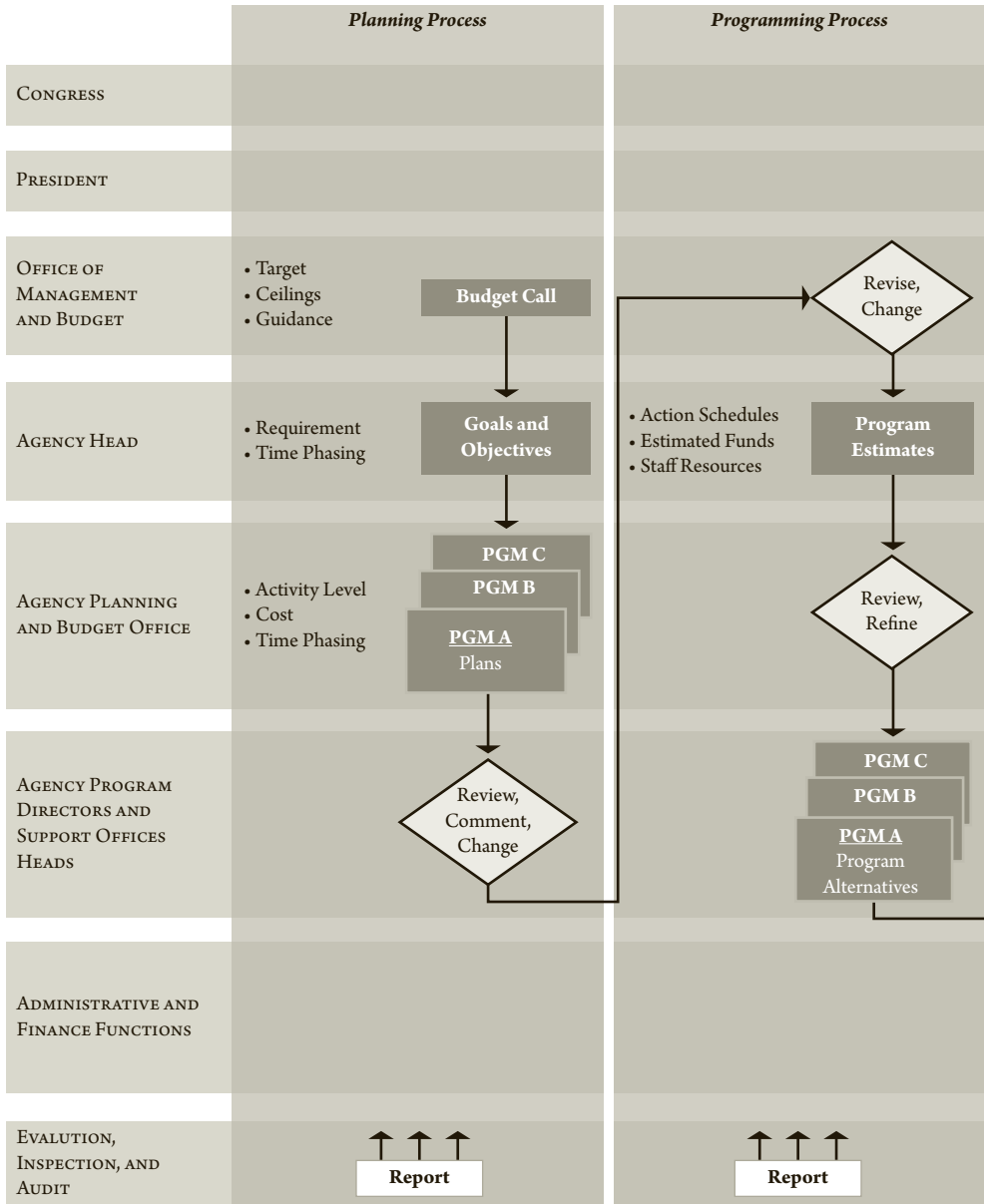
### **Planning, Programming, and Budgeting System**

PPBS, implemented by presidential directive in the 1960s, was intended to be the integrated process by which Federal organizations planned, managed, and made decisions about the types, nature, and funding of programs. Where PPBS was successfully integrated into the decision-making process of a department or agency, the concept provided a sound basis for determining, monitoring, and accounting for Federal programs and activities. There are several phases involved in a PPBS:

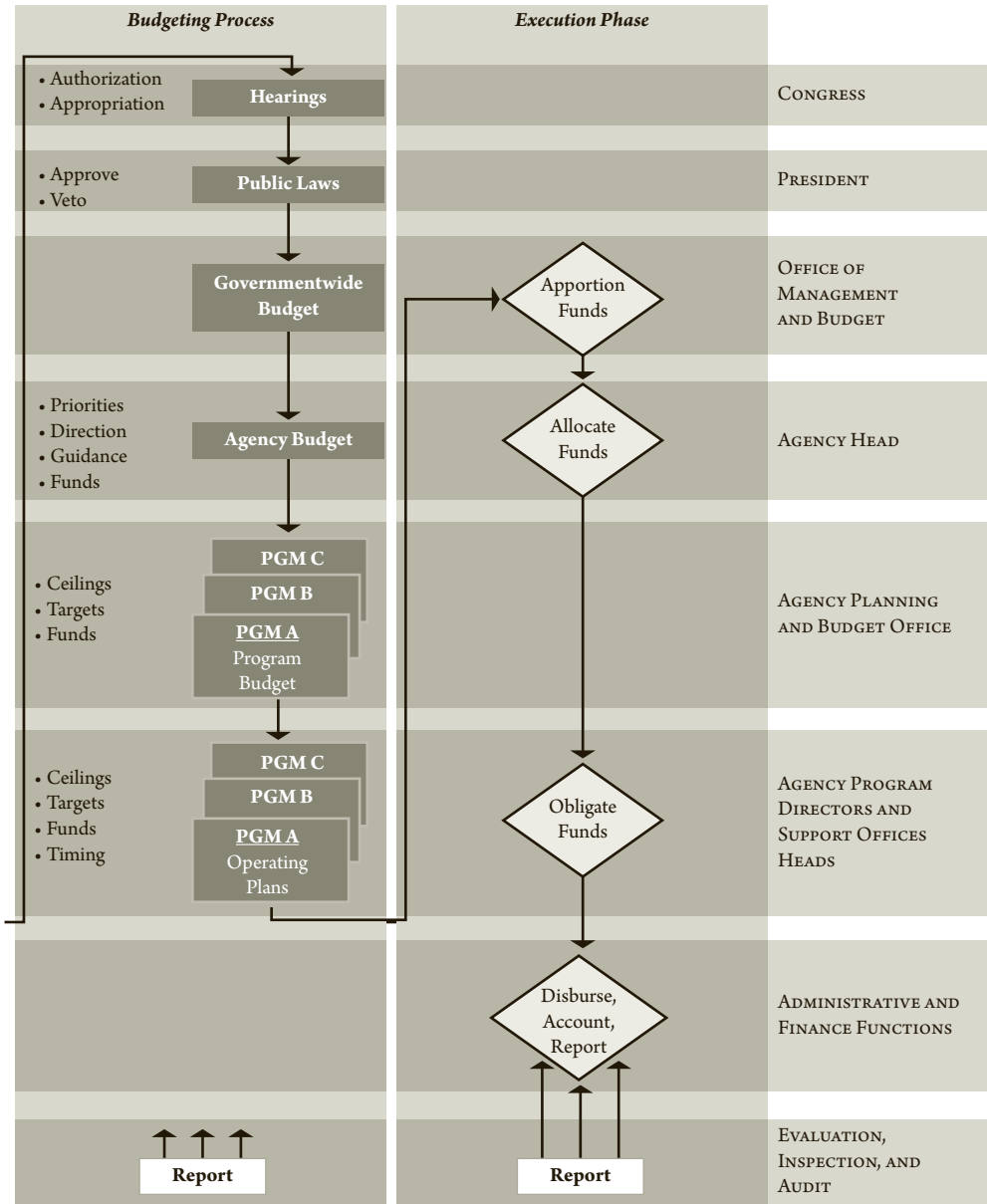
- *Planning.* Study agency objectives; construct alternative approaches to achieve objectives; identify and assess contingencies.
- *Programming.* The structure of activities aligning with an agency's objectives and expected outputs in relation to the estimated cost of resources needed to attain those objectives and outputs.
- *Budgeting.* Request and defense of funds to the President and Congress in support of the agency's programmed activities. As approved, the budget request became the operating plan for the agency.
- *Execution.* Subsequently, the DoD formalized a fourth phase: the execution phase. Thus, beginning in the 1990s, one may encounter the term *PPBES*.

The purpose of PPBS is to shift the focus away from annual planning, which results in incremental changes, to a longer-range planning approach. Instead of focusing on the budget (what the agency needs for the next year), PPBS focuses on a plan for where the agency needs to be in five years and then works backward to determine what the requirements will be for each of the next five to six years (the budget year plus five program years). This approach has been adopted by the agencies mentioned earlier whose core activities (such as building aircraft carriers, U.S. Coast Guard cutters, or satellites) require years of planning and construction to complete. Multiyear planning also permits agencies to properly consider initiatives that have an initial cost but can provide long-term savings, such as consolidating operations (i.e., DoD's base realignment and closure process). Exhibit 4.3 highlights the several concurrent activities of PPBES.





**EXHIBIT 4.3 Responsibilities for Planning, Programming, Budgeting, and Execution in the Federal Government**



**EXHIBIT 4.3 Continued**

**FEDERAL ACCOUNTING: PROCESS, DEFINITIONS,  
TRANSACTIONS, LIFE CYCLE**

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The government-wide uniform accounting and reporting standards are developed by the Federal Accounting Standards Advisory Board (FASAB). The FASAB is an advisory board jointly sponsored by the Department of the Treasury, OMB, and the Government Accountability Office (GAO). After the FASAB completes its due process and deliberations related to particular accounting standards or authoritative guidance and following a waiting period during which the director of OMB or the Comptroller General can object, the standard becomes part of generally accepted accounting principles (GAAP) for the Federal Government. FASAB's standards are then incorporated into the Federal Government's standard general ledger account and transaction structure by the Treasury Department. The Federal Financial Management Improvement Act of 1996 (FFMIA) (Public Law [P.L.] 104-208) sets forth a mandate that agencies comply with "applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level."

Federal accounting, like other accountancy specialties, adopted or requires the use of phrases, terms, concepts, and conventions having specialized meaning. These words have significance to practitioners involved directly with a Federal department or agency or indirectly through audits, Federal contracts, grants, loans or loan guarantee programs, or other types of Federal financial assistance.

A Federal entity's systems of accounting, controls, and financial reporting must be sufficiently integrated to provide complete financial disclosure of each appropriation, budgetary authority, and all other resources received under some law of Congress. That same system must also be capable of providing data on several accounting bases: types of funds, specific obligations, accruals, costs and accrued expenditures, and cash disbursement, to cite a few. Additionally, this financial system must provide financial information by the entity's component organizations and programs. The system may have to report by states, and tens of thousands of counties, cities, academic institutions, and nonprofit organizations, to mention a few more accounting units.

**Basis for Federal Accounting**

For the better part of 200 years, Federal accounting was equated almost exclusively with budgetary accounting or cash accounting and dealt with monitoring compliance with the legal restraints and controls over congressionally appropriated funds. Of itself, however, the budgetary accounting basis did not provide a full accounting, was not an accurate and timely reporting of programs, and did not provide for reporting of long-term investments, capital versus operating expenses, or outputs and outcomes. Other accounting bases require an agency's system to accumulate total costs, true costs, full costs, and accrued costs, whatever the source of financial support or however many appropriations were

assigned to an entity. This latter accounting need requires the agency to also perform *proprietary accounting*.

*Budgetary accounting* is construed by some to be a separate accounting requirement or even a separate system, loosely defined. Budgetary accounting, however, is more in the nature of a bookkeeping refinement of the overall fund accounting, operational accounting, and cost accounting of a Federal Agency with all data emanating from a single accounting and reporting system. In practice, concurrent accounting entries are made to both budgetary accounts and other accounts, at times referred to as proprietary accounts. The proprietary accounts are not separate but are part of an accounting and reporting continuum for each congressional appropriation.

There are not two financial systems operating in parallel within a Federal Agency. In practice, a Federal Agency’s single integrated financial system must record all financial activity for the agency at the elemental transaction level and provide both budgetary and proprietary data from this single system. Exhibit 4.4 highlights the economic or fiscal activities for which there must be an accounting, budgetary or proprietary. In total, there

		Responsible Body				
		Congress	Treasury	OMB	Individual Entities	
Accountable Event	1	Appropriation of the Money				
	2	Allocation of the Money				
	3	Other Budget Authority				
			4	Appropriation Warrant		
				5	Apportionment	
					6	Allotment
					7	Allowances
					8	Commitments
					9	Obligations
					10	Accrued Expenditures
					11	Costs
					12	Accruals
			13	Disbursement		
			14	Expired Accounts		
			15	Merged Accounts		

**EXHIBIT 4.4 Financing Federal Programs and Activities**

are some 15 specific events in the life cycle of a Federal transaction for which an accounting entry must be made.

### **Budgetary Accounting**

The term *budgetary accounting* encompasses a breadth of accounting transactions, each with legal or economic implications. In Exhibit 4.4, the events beginning with the congressional appropriation (event 1) through the accruing of the expenditure (event 10) are generally viewed as the scope of Federal *budgetary accounting*.

### **Fund Accounting**

In Federal accounting, the term *fund* is synonymous with a congressional appropriation or legal budget authority directing an agency to incur obligations and make expenditures on behalf of the Federal Government. In some instances, an agency is responsible for a single appropriation (i.e., fund), which simplifies the accounting considerably. More common is the circumstance where an agency is responsible for more than one appropriation or source of budget authority.

### **Nature of Congressional Authorizations and Appropriations**

Funding of Federal operations by Congress is a two-step process: (1) the congressional “authorization” to operate and spend for a program or activity; and (2) the subsequent congressional “appropriation” of monies providing specific expenditure authority. Both steps are necessary; mere authorization of a program by Congress does not grant permission to a Federal Agency to spend Federal money.

Before obligations or expenditures can be incurred or cash disbursed by a Federal Agency, an appropriation must be made available by Congress. *Availability* means that (1) an appropriation law exists, which grants an agency permission to enter into obligations or make expenditures; and (2) this appropriation must be current or unexpired for the period during which the obligation or expenditure occurs. The use or availability of appropriations, once enacted by Congress and then apportioned by OMB, is governed by:

- The terms of the appropriation act.
- Legislation, if any, authorizing the activity or program.
- General statutory provisions that allow or prohibit certain uses of appropriated funds.
- Numerous Treasury Department and OMB regulations.
- General rules that have been developed through decisions of the Comptroller General (who heads GAO) and the courts.<sup>2</sup>

### **GAO Decisions: Like Law to Agencies**

The preceding sources, together with the Constitution and GAO decisions, form the basis of the legal precedence governing Federal appropriations. Based on other laws,

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<sup>2</sup> U.S. GAO, *Principles of Federal Appropriation Law*, 2004 pp. 1–2.

the Comptroller General has the authority to render GAO decisions concerning the availability of appropriated funds, often relating to transactions by disbursing, certifying, and other accountable officers. Individual claimants may also request review or reconsideration of earlier settlements disallowing their claims in whole or part by the Comptroller General. GAO decisions are binding on the executive branch but not on a private party who, if dissatisfied, retains the right to pursue the issue in the courts.

### ***“Laundering,” “Changing Color of Funds” Not Permitted***

Federal entities cannot thwart the intent of Congress by transferring part of their appropriation to another entity. GAO has maintained that funds appropriated under one law are not available by means of a transfer to a working fund or another appropriation to be spent for purposes not permitted under the original appropriation from which the transfer was made. That is, the original terms and conditions of an appropriation cannot be laundered, or another appropriation or fund cannot be used to change the color (i.e., the terms, conditions, limits, period of availability, or other prohibitions) of an appropriation or fund. The use of a specific appropriation to pay obligations under another appropriation even during a temporary exhaustion of funds is also in violation of 31 United States Code (U.S.C.) 628, even though repayment may be contemplated after the supplemental appropriation is made.<sup>3</sup>

### ***Other Spending Authority***

An appropriation law is the most common means of providing other spending authority. In some cases, though, the authorizing legislation may provide *authority to borrow* or *contract authority*.

- *Authority to borrow.* The statutory authority that permits a Federal Agency to incur obligations and make payments for specified purposes out of borrowed monies.
- *Contract authority.* The statutory authority under which contracts or other obligations may be entered into prior to a congressional appropriation for the payment of such obligations. The later-enacted appropriation provides the cash to liquidate such obligations.

It is important to note that budget authority does not authorize a Federal entity to incur new or additional obligations but merely to meet earlier obligations and liabilities of the government.

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<sup>3</sup> See also 36 Comp. Gen. 386.

## NATURE OF CONGRESSIONAL ALLOCATIONS

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An *allocation* of an appropriation is a transfer by Congress of obligational authority from one Federal entity to another to carry out the purpose of the parent appropriation. An allocation is an amount of obligational authority set aside in a transfer appropriation account (i.e., an allocation account) to carry out the purposes of the parent appropriation or fund. A “transfer appropriation account” is a separate account established to receive (and later obligate and expend) allocated appropriations from a parent appropriation under the control of another department or agency.

## NATURE OF AN OMB APPORTIONMENT

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An *apportionment* is a formal distribution made by OMB to Federal entities of amounts available for obligation from an appropriation or other budget authority. OMB apportions appropriated monies to agencies by (1) making specific amounts available for specified time periods (generally the fiscal quarters of the year, which are referred to as “A” apportionments) or (2) making specific amounts available for particular activities, projects, objects, and so on (referred to as “B” apportionments). The apportionment of funds is supported by a formal written notice from OMB to the Federal Agency describing the specifics of any subdivisions of a congressional appropriation.

## NATURE OF FEDERAL ENTITY ALLOTMENTS

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For control purposes, heads of departments and agencies must limit or restrict the use of the apportioned appropriations or other budget authority or funds within their organizations. The term used for this action is referred to as an *allotment*. An allotment is a formal delegation of authority by the head of a Federal entity to employees to incur obligations within the amount allotted. An *advice of allotment* is the formal notification to agency allottees of their responsibility for funds.

## NATURE OF FEDERAL ALLOWANCES

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In some agencies, funds are further subdivided through issuance of *advices of allowances* to agency personnel. Unlike allotments, agencies may not record journal entries to formalize this subaccounting for agency funds. The detailed accounting and fund tracking occurs at program or allottee levels in an agency, although there may be instances in which certain funds are recorded and accounted for above allottee levels.

## NATURE OF FEDERAL OBLIGATIONS

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An obligation is a legal event, meaning two or more parties have rights, liabilities, and obligations. From an accounting perspective, the incurrence of an obligation is an economic event that must be entered in the official records of the government. Thus, the term *obligation* has accounting and legal connotations. Obligations are the amounts of orders placed, contracts awarded, services received, grants issued, and similar transactions during a fiscal period that will require payments in the same or a future period. Once an obligation is incurred with respect to a specific appropriation or budget authority, the same amount cannot be used for another obligation.

### Legal Form for Federal Obligation

At times, references are made to *commitments*. Commitments cannot legally encumber an appropriation, as do obligations. Commitments are not legal reservations or obligations of appropriated funds (i.e., a commitment is not one of the eight legal forms that an obligation must take to be legally binding on the Federal Government). The Supplemental Appropriations Act of 1955 (Section 1311 of the Revised Statutes) requires that an obligation of the Federal Government be supported by specific documentary evidence. There are eight forms for valid obligations that may be documented:

1. A binding agreement, in writing, between parties in a manner and form, and for a purpose authorized by law, executed before the expiration of the appropriation period of availability for obligation of the appropriation or fund for specific goods to be delivered, real property to be purchased or leased, or work or services to be performed
2. A valid loan agreement showing the amount of the loan to be made and the terms of repayment
3. An order required by law to be placed with a government agency
4. An order issued pursuant to a law authorizing purchases without advertising, when necessitated by public exigency or for perishable subsistence supplied or within specific monetary limitation
5. A grant or subsidy payable from appropriations made for payment of, or contributions toward, sums required to be paid in specific amounts fixed by law or in accordance with formulas prescribed by law; or payable pursuant to agreement authorized by, or plans approved in accordance with an authorized law
6. A liability that may result from pending litigation brought under authority of law
7. Employment or services of persons, or expenses of travel in accordance with law, and services performed by public utilities
8. Any other legal liability of the government against an appropriation or funds legally available



All paid obligations must meet one of the preceding legal criteria and be supported by relevant documentation. Upon failing to meet one of these criteria, the agency has no authority to make payment since there is no legally binding obligation. In dealings with the Federal Government, there is no implied or apparent legal authority with respect to Federal obligations or liabilities.

### **Other Conditions for Obligations**

In addition to meeting one of the eight legally required forms, an obligation may be incurred only if there is a current or unexpired appropriation in existence at the time the obligation is incurred. General rules have arisen and GAO decisions have been rendered that define conditions under which obligations may be incurred. Some of these relate to:

- The general rule regarding obligation of a fiscal year appropriation for payments to be made in a succeeding year is that the contract or other instrument imposing the obligation must be made within the fiscal year sought to be charged and the contract must be to meet a bona fide need of that fiscal year (33 Comp. Gen. 57, 61).
- The bona fide need of the service of a particular year depends upon the facts and circumstances of the specific case; no general rule for application to all situations exists (73 Comp. Gen. 155, 159).
- The obligated balance of an appropriation available for a definite time period must be transferred at the end of the second [now fifth] full fiscal year following the close of the period of availability of the appropriation. (The transfer will be to the successor “M,” or merged, accounts of the Treasury Department.) (7 Comp. Gen. 19.6; P.L. 101–510).
- Working capital or revolving-type funds cannot operate to divest appropriated funds of their identity or change the requirement that appropriated funds must be expended solely for the purpose for which the appropriation was made available (26 Comp. Gen. 545, 548).
- The use of a specific appropriation to pay obligations under another appropriation, even during a temporary exhaustion of funds, is in contravention of 31 U.S.C. 628, even though repayment may be contemplated after a supplemental appropriation might be made (36 Comp. Gen. 368).

In practice, confusion regularly arises over whether appropriated funds may be obligated in one fiscal year and liquidated in a succeeding fiscal year. Common areas of uncertainty include those listed next.

- The Comptroller General has stated that, unless prohibited by the terms of the authorizing or appropriating legislation, this practice is acceptable and legal.
- Unless specifically prohibited or precluded by law, it is not necessary for the obligation and its liquidation or settlement to occur in the same fiscal year.

- Legally, valid obligations remain available to meet expenditures for years after the fiscal year in which the appropriation expired.
- No new obligations may be entered into after an appropriation has expired, but funds from the expired appropriation may be used to pay legally incurred obligations of the appropriation.
- Amounts from one appropriation or working capital or revolving fund cannot be used to incur obligations or make expenditures for a “customer,” or other appropriation, that would have been prohibited by the conditions of the first appropriation.

### Recording Obligations

Once funds are obligated by Federal executives, a formal accounting entry and a budgetary accounting entry must be made in the entity’s system to record the obligation of allotted funds. Federal accounting standards require that an agency match every obligation to an appropriation or other budgetary authority and then create an accounts payable or make a payment for previously obligated amounts when due.

### Nature of Expenditures

*Expenditures* are defined by OMB and the Department of Treasury as disbursements or outlays, or the amount of checks issued, interest accrued on public debt, or other payments made by a Federal entity (including advances to others), net of any related refunds and reimbursements. However, an *appropriation expenditure* is a reduction in an appropriation or other budget authority through the receipt of goods and services ordered. The *expended appropriation* status is not dependent upon whether the related obligations have been paid or an invoice received. The *expending* of an appropriation reverses the earlier entry made to record the formal obligation (i.e., also referred to as undelivered orders) of appropriated funds.

Each time an expenditure is accrued, an earlier obligation must be reduced by a formal accounting entry—a budgetary accounting entry. In recent years, OMB adopted a definition of expenditures that is the same as *outlays*. The latter term is defined in OMB Circular A-11 as “a payment to liquidate an obligation.” OMB uses *expenditure* and *net disbursement* interchangeably with the term *outlay*. Thus, after many years of support by GAO, the term *accrued expenditures* seems to be passing from the lexicon of governmental accounting.

## PROPRIETARY ACCOUNTING

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As noted earlier, the term *proprietary accounting* refers to that accounting performed by Federal entities within the nonbudgetary accounts. Generally, proprietary accounting is concerned with a Federal entity’s assets, liabilities, net residual Federal position or cumulative Federal investment, any revenues or receipts, and expenses and costs.

In Exhibit 4.4, events beginning with accrued expenditures (event 10) through the final accounting performed in the merged accounts (event 15) are generally viewed as the scope of Federal proprietary accounting.

**Accrual Accounting**

The proprietary basis of accounting requires costs incurred for goods and services benefiting more than one fiscal year to be recorded as assets and reported as costs when consumed or used, irrespective of when payment is made for the goods or services. Increasingly, accrual or proprietary accounting is the basis for recording and reporting of financial information by Federal Agencies. The nature of Federal proprietary accounting closely parallels that of a corporation complying with GAAP for the private sector. Exhibit 4.5 illustrates an example of a purchase order placed in one fiscal period, the goods received in another period, the goods used or consumed in a third, and paid for in a fourth fiscal period.

The nature of this particular illustration requires that the accounting be performed in four fiscal periods:

1. A budgetary entry is made in the first period to record the obligation incurred (a budgetary entry).
2. In the second period, an entry is required for goods received (a proprietary entry) and another for the reduction of the earlier outstanding obligation (a budgetary entry).
3. When the goods are consumed in the third period, an entry must be made to record the cost of the current period (a proprietary entry).
4. In the fourth period, when payment is made, an entry is required for the cash disbursed (a propriety entry).

Economic Event/Activity	Recorded in Period Which...			
	Order is Placed	Materials are Delivered	Materials are Used	Vendor is Paid
Order Placed for Material	As an obligation			
Materials Received		Liquidate earlier obligation		
Add to Inventory		Increase inventory account		
Billed by Vendor		Increase payable account		
Used/Consumed Inventory			As an applied cost or expense	
Pay Vendor				As a cash disbursement
<b>Fiscal Period</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>

**EXHIBIT 4.5 Transaction Life Cycle for Purchase of Materials**

### Accounting for Assets

*Assets* are defined as tangible or intangible items owned by the Federal Agency that would have probable economic benefits that can be obtained or controlled by the Federal Agency.<sup>4</sup> These assets include cash, investments, real and personal properties, and also claims of the Federal entity against non-Federal Agency or parties (e.g., accounts receivable, interest receivable, amounts due from Federal advances, and advances or prepayments to these non-Federal entities or parties). With some exceptions, assets are initially recorded by a proprietary accounting entry when received at purchased costs or donated values, regardless of when payment is made or the asset is used or consumed.

### Accounting for Liabilities

FASAB and OMB define a Federal liability as a “probable future outflow or other sacrifice of resources as a result of past transactions or events.” The liabilities grouping of accounts include an enormity of transactions and events such as accounts payable, end-of-period accrual liabilities, Federal commitments and guarantees legally assumed or entered into, contingencies, damages from litigious proceedings, and so on. Liabilities are recorded as proprietary entries in a Federal Agency’s accounts in the period incurred and removed from these accounts in the period paid or liquidated. Liabilities represent amounts owed and are not dependent upon receipt of an invoice or request for payment. Also, liabilities must be reported regardless of whether Federal funds are available or authorized for their payment.

### Accounting for Revenues or Receipts

No agency may collect receipts and earn revenue unless specific authorization is provided by Congress. An agency may have the authority to collect receipts, but such receipts are unavailable for expenditure by that collecting agency. Inflows from revenue and other financing sources would be those resources that the government demands, earns, or receives by donation.

From an accounting perspective, exchange-type revenues are to be recognized when goods or services are provided to the public or to another government entity at the actual price received or receivable under established pricing arrangements. The accounting for nonexchange revenues or inflows of resources is recognized when:

1. A specifically identifiable, legally enforceable claim arises, and
2. To the extent that collection is probable (more likely than not) and the amount is reasonably estimable. The accounting for exchange and nonexchange revenues is reflected in proprietary-type accounts.

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<sup>4</sup> Federal Accounting Standards Advisory Board, *FASAB Handbook of Federal Accounting Standards and Other Pronouncements, As Amended, Consolidated Glossary*, June 2011.

**Accounting for Expenses**

Federal expenses are defined as outflows or other expending of assets or incurring liabilities (or both), from providing goods, rendering services, or carrying out other activities related to an entity's programs and missions, the benefits from which do not extend beyond the present operating period. Expenses are charged to proprietary type expense accounts.

**Accounting for Costs**

Costs, depending upon the nature of the transaction, may be charged to operations immediately and recognized as an expense of the period. Costs might also be charged initially to an asset account (i.e., "capitalized") and then transferred to an expense account in a subsequent period upon being used. Most often, in Federal entity accounting, costs are synonymous with expense. Formal, proprietary-type accounting entries must be made for each cost incurred, regardless of when payments are made or whether invoices have been received.<sup>5</sup>

**Accounting for Disbursements**

Disbursements in the Federal Government are payments of cash that take a variety of forms, including checks issued, payments made, letters of credit drawn down, and electronic fund transfers. In recent years, OMB has adopted a definition of disbursements that includes expenditures and outlays. Expenditures and outlays are proprietary-type accounting transactions that are recorded for the amounts of checks issued, interest accrued on public debt, and other payments, such as advances and Federal loans.

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<sup>5</sup> These definitions are set forth by OMB in Circular A-34, *Instructions on Budget Execution* (Rescinded 6/27/2002, and superceded by OMB Circular No. A-11, Part 4), and GAO in its *Accounting Guide* (GAO/AFMD-PPM-2.1), September 1990.



# **5 FEDERAL FINANCIAL STATEMENTS**

## **INTRODUCTION TO FEDERAL FINANCIAL STATEMENTS**

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The financial statements issued by component entities of the Federal Government differ significantly from the statements issued by commercial entities, not-for-profit organizations, or state and local government entities. In addition, the requirements for Federal Government financial statements and their requisite form and content also differ between the three branches of the Federal Government.

## **HISTORICAL EMPHASIS OF FEDERAL FINANCIAL REPORTING**

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Historically, within the Federal Government, considerable effort was expended to meet only legally required reporting mandates of Congress. While such reports were important, these requirements were not the reporting information most needed by Federal entity executives to manage activities and operations properly. As a result, significant changes and improved financial reporting requirements were implemented by the Federal Government in the 1990s.

For the prior 200 years, Congress and executives of Federal entities were almost exclusively concerned with appropriated amounts, the status of apportioned budget authority, and the rate of obligation and expenditure. So long as the obligated and expended amounts remained below the amounts appropriated by Congress, few expressed any concern about the absence of other types of data. Information presented by Federal entities for both external and internal uses were essentially the dollar values of obligated balances and cash expenditure amounts.

In the 1940s and 1950s, Congress, the Government Accountability Office (GAO), the Office of Management and Budget (OMB), Federal executives, and two Hoover Commissions recognized the limitations of obligation and expenditure accounting and reporting. This type of stewardship reporting was not sufficient to meet the scope of the financial management needs of the government. In the 1960s and 1970s, Congress became concerned that Federal entities were not managing programs to ensure that the rates of expenditures were consistent with program plans and desired economic thrusts and were not reflective of promised accomplishments or results. As a result, laws imposed fiscal and performance restrictions on

programs. Time limitations were placed on the period for obligation of appropriated funds and on the time periods by which the Federal monies had to be fully expended. If both time limitations were not met, the entity's funding authority might lapse.

## **HIERARCHY OF ACCOUNTING PRINCIPLES FOR FEDERAL ENTITIES**

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For the 200 years preceding passage of the Chief Financial Officers Act of 1990 (CFO Act), Congress did not require, nor did Federal entities apply, consistent and uniform accounting and reporting standards, prepare annual agency financial statements, or have independent audits performed over financial statements. This changed with the CFO Act. Also in 1990, the newly established Federal Accounting Standards Advisory Board (FASAB) set forth a basic objective that Federal accounting and financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and for reporting that Federal expenditures were made in accordance with appropriations laws.

FASAB suggested that there could be several levels of accountability: policy, program, performance, processes and procedural, and legal. In its statement of objective, FASAB noted that this accountability must have utility to a variety of users, which FASAB categorized into four groups:

1. Individual citizens (e.g., taxpayers, voters, or service recipients of Federal assistance)
2. Congress (individual members, committees, plus legislative agencies with budget and other Federal financial responsibilities, such as the Congressional Budget Office [CBO] and GAO)
3. Federal executives and those with oversight responsibilities (including the President and those acting as the President's agents)
4. Program managers (i.e., those Federal entity executives responsible for operating plans, program operations, and budget execution).<sup>1</sup>

To meet the needs of this myriad of users, FASAB recommended that financial statements and reports be issued for individual Federal entities and for all entities, in total, government-wide.

## **FEDERAL GOVERNMENT'S ACCOUNTING HIERARCHY**

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The hierarchy of accounting for Federal entities is established by the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct

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<sup>1</sup> Financial Accounting Standards Advisory Board, *Objectives of Federal Financial Reporting—Statement of Recommended Accounting and Reporting Concepts*, July 1993.



Rule 203, *Accounting Principles*. The interpretation under Rule 203 designates FASAB as the body to establish accounting principles for Federal Government entities through the insurance of Statements of Federal Accounting Standards (SFFAS). SFFAS 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application Standards Issued by the Financial Accounting Standards Board*, established the hierarchy as follows:

1. Officially established accounting principles consist of FASAB SFFAS and interpretations. FASAB standards and interpretations will be periodically incorporated in a publication by the FASAB
2. FASAB technical bulletins and, if specifically made applicable to Federal reporting entities by the AICPA and cleared by the FASAB, AICPA Industry Audit and Accounting Guides
3. Technical releases of the Accounting and Auditing Policy Committee of the FASAB
4. Implementation guides published by the FASAB staff as well as practices that are widely recognized and prevalent in the Federal Government

In the absence of guidance provided by the preceding hierarchy, the auditor of a Federal Government entity may consider other accounting literature, including:

- FASAB concept statements
- The pronouncements referred to in the second category above when not specifically made applicable to Federal reporting entities by the FASAB
- The pronouncements of other accounting and financial reporting standards-setting bodies, such as the Financial Accounting Standards Board (FASB), Governmental Accounting Standards Board, International Accounting Standards Board, and International Public Sector Accounting Standards Board; professional associations or regulatory agencies; and accounting textbooks, handbooks, and articles

## **FEDERAL REPORTING ENTITY**

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There is only one overall economic entity: the Federal Government as a whole. But, on a daily basis, the Federal Government operates as a network of somewhat autonomous entities: departments, agencies, subdepartments and subagencies, commissions, and other Federally funded or Federally assisted organizations. Each entity manages activities, can legally obligate the government, and is authorized by Congress to spend Federal monies.

Until the 1990s, there had been no uniform resolution of what constituted a Federal accounting and reporting entity. The individual congressional appropriations were viewed by most as the “accountable” entity, while the departments and operating agencies were viewed as the “reporting” entities. This distinction was an impediment to implementing consistent, uniform cost-based, accrual financial reporting within Federal departments and

agencies, between these and other entities of the government, and for the government as a whole. Others, with different responsibilities, believed that the budget accounts or Treasury accounts (and these do not provide for the same accounting) provided the more accurate and revealing financial disclosures. Still others thought the primary reporting entity should be special funds and trusts established by various laws. Further complicating Federal accountability was the fact that congressional appropriations and other forms of spending authority were not clearly or neatly aligned by Federal departments and agencies. A final void in the Federal reporting was that no financial statements were prepared to report on the operations of the Federal Government as a whole.

### **Limitations of Appropriation, Cash Basis Accounting**

Historically, Federal accounting and reporting for some departments and agencies was based on congressional legislation that provided a single appropriation to a single Federal Agency as the primary financing resource for operations, which considerably simplified accounting and reporting. However, this was not the norm, particularly for the larger Federal departments, which frequently had responsibility for two or more congressional appropriations. When a single department or agency is responsible for multiple appropriations, these appropriations supported a variety of operations and usually a combination of programs; each appropriation was separately reported. Then, at its discretion, Congress might opt to not provide funding through an appropriation at all but rather through another form of spending authority whereby the agency is authorized to first spend Federal money and then report to Congress for “reimbursement.” In other instances, an agency’s operations are supported by none of these funding devices but rather through a congressionally mandated “allocation” of money from another agency’s appropriation, raising the issue as to which agency should report what amounts and how. Financial information on individual Federal entities and programs arrayed only by appropriation or budget authority was of limited value to Federal executives and managers in operating the day-to-day activities. These macro-level reports and statements on appropriation balances, essentially a cash-basis reporting, provided few clues to the economy, efficiency, or relative effectiveness of Federal operations.

Resolution of this accountability and reporting conundrum of 200 years began in earnest with passage of the CFO Act that mandated Federal Agencies to annually prepare entity-wide financial statements for all resources for which they were responsible, using the uniformly applicable accounting standards for Federal Agencies, and that these financial statements be independently audited. By 1994, FASAB recommended Federal departments and agencies to report on all of their stewardship responsibilities in a single set of financial statements, and not separately, by individual appropriations and funding sources. FASAB, in its accounting concepts, stated that a basic postulate of accounting is that accounting information pertains to entities (meaning a Federal Agency or organization) and that, therefore, reporting should be performed by the organization regardless of the numerous and distinct devices used to fund the organization.

### **Breadth of Federal Entity Accountability**

Federal entities must provide financial data on a variety of reporting bases, often for differing time periods and by many organizational structures (e.g., individual departments and agencies, subordinate offices, bureaus, branches). Reporting details must include an accounting by appropriations of related financial positions, obligations, expenditures, cash disbursements, and costs of authorized programs, products, activities, and services managed. Also, systems of Federal entities are expected to provide a ready and accurate reporting by every congressional district in America for an entity's programs that could impact tens of thousands of states, counties, cities, towns, and other governmental units receiving Federal financial assistance. Not to be overlooked, several agencies make payments directly to tens of millions of individual citizens, each requiring an individual "account" and requiring some type of reporting. Such an accounting and financial reporting has no counterpart in or out of government.

This chapter describes the form and content of the Federal Government's financial statements for both individual Federal entities and for the consolidated reporting of the U.S. government as a whole.

### **REPORTING BY DEPARTMENTS, AGENCIES, AND THE GOVERNMENT AS A WHOLE**

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Executive branch agencies subject to the requirements of the CFO Act, as amended by the Federal Financial Management Act of 1994, Federal Financial Management Improvement Act of 1996, Reports Consolidation Act of 2000, or Accountability of Tax Dollars Act of 2002, prepare their financial statements in accordance with the policies prescribed by OMB. The latest guidance issued by OMB is Circular A-136, *Financial Reporting Requirements*.<sup>2</sup> Several of the components of the legislative branch of government have elected to prepare their financial statements based on the guidance contained in this bulletin, but are not required to comply with all of its provisions. To date, the judicial branch of government has elected not to issue financial statements. The majority of the following discussion will focus on financial statements prepared in accordance with OMB Circular A-136.

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<sup>2</sup> This circular establishes a central point of reference for all Federal financial reporting guidance for executive branch departments, agencies, and entities required to submit audited financial statements, interim financial statements, and Performance and Accountability Report (PAR) or Agency Financial Report (AFR) under the CFO Act (Public Law [P.L.] 101-576), the Government Management Reform Act of 1994 (GMRA) (P.L. 103-356), the Accountability of Tax Dollars Act of 2002 (ATDA) (P. L. 107-289), and Annual Management Reports under the Government Corporations Control Act (31 U.S.C. [United State Code] & 9101 et seq.)

## Performance and Accountability Reports

Each agency subject to the CFO Act or Accountability of Tax Dollars Act is required to annually submit their audited financial statements in a Performance and Accountability Report (PAR), which combines performance and financial reporting into a single document. In addition to the base financial statements, the PAR will include a management's discussion and analysis (MD&A), a performance section (where the agency will discuss its strategic goals), the Independent Auditor's Reports, the Required Supplementary Stewardship Information, and other information, such as Improper Payments Information Act of 2002 reporting details. In conducting an audit of a Federal Agency, the auditor is responsible for forming an opinion on the basic financial statements taken as a whole. The MD&A and other information that are not parts of the basic financial statements, but are required by FASAB and OMB Circular A-136, are subjected only to certain limited procedures. The auditor does not opine on the information presented outside of the basic statements. The remainder of this chapter focuses on the six financial statements on which the auditor will opine:

1. Statement of financial position or balance sheet (Exhibit 5.1)
2. Statement of net cost (Exhibit 5.2)
3. Statement of changes in net position (Exhibit 5.3)
4. Statement of budgetary resources (Exhibit 5.4)
5. Statement of custodial activity (Exhibit 5.5)
6. Statement of social insurance (SOSI) and statement of changes in social insurance amounts (SSCSIA) (Exhibit 5.6)

## Government Corporations

The financial statements of Federal departments, agencies, and other entities must comply with 31 U.S.C. 3515 and other legal criteria for presenting the financial position and results of operations of Federal entities. The OMB circulars and bulletins prescribing the form and content of Federal financial statements essentially incorporate the Federal financial accounting concepts and standards researched and recommended by FASAB. OMB Circular A-136 does, however, also mention government corporations (GCs). GCs are not responsible for complying with 31 U.S.C. 3515 but instead must comply with 31 U.S.C. 9101 through 9110.

GCs are subject to the Government Corporation Control Act (GCCA) of 1945. The GCCA was intended to make GCs more accountable to Congress while allowing the freedom to pursue commercial activities. The CFO Act of 1990 amended the GCCA to strengthen the audit and management reporting requirements, but it did not include a definition nor did it include classification criteria for GCs.

There are two types of GCs: mixed ownership corporations and wholly owned GCs. Examples of mixed ownership GCs are listed next.

- Federal Deposit Insurance Corporation
- Federal Home Loan Banks
- National Credit Union Administration
- Resolution Trust Corporation

Examples of wholly owned GCs are listed next.

- Commodity Credit Corporation
- Community Development Financial Institutions Fund
- Export-Import Bank of the United States
- Government National Mortgage Association

According to 31 U.S.C. 9109, “Exclusion of a Wholly Owned Government Corporation from This Chapter,” when the President of the United States considers it practicable and in the public interest, the President may include in the budget submitted to Congress under 31 U.S.C. 1105, “Budget Contents and Submission to Congress,” a recommendation that a wholly owned GC be deemed an agency for fiscal matters. If approved, the corporation is deemed to be an agency under Chapter 11 and for fiscal matters for fiscal years beginning after the year of approval.

Very similar to Federal Agencies, GCs are required to submit their reports to OMB, GAO, and Congress no later than 45 days after the end of the fiscal year (unless they have registered equity securities with the Securities and Exchange Commission, at which point they are exempt from the accelerated dates). The 45-day deadline is a permanent requirement for all GCs regardless of fiscal year.

Unlike Federal Agencies, however, there is no requirement that a GC follow FASAB accounting. GCs may elect to follow FASB accounting or any other accounting they deem appropriate for their purposes. Prior to the amendment to the GCCA in 1990 by the CFO Act, the GCCA required audits to be reviewed for consistency with commercial accounting practices.

Per statute, a GC must submit an “Annual Management Report” to Congress no later than 180 days after the end of the fiscal year. The report includes the following financial statements:

- Statement of financial position
- Statement of operations
- Statement of cash flows
- Reconciliation to the budget report of the GC, if applicable

- Statement on internal accounting and administrative control systems
- Audit report

## FEDERAL FINANCIAL STATEMENTS

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The six principal financial statements required of Federal entities discussed in this chapter include:

1. Statement of financial position or balance sheet (Exhibit 5.1)
2. Statement of net cost (Exhibit 5.2)
3. Statement of changes in net position (Exhibit 5.3)
4. Statement of budgetary resources (Exhibit 5.4)
5. Statement of custodial activity (Exhibit 5.5)
6. SSI and SCSIA (Exhibit 5.6)

To be complete, a Federal entity's financial statement must also include several required footnotes, plus other notes necessary to describe the financial and other activity of the specific Federal entity. Additionally, the prescribed Federal financial statements must contain other information including:

- *Supplementary stewardship information* relating to property, plant, and equipment (PP&E); entity investments; and program-related risks
- *Supplementary information*, including a statement on budgetary resources, custodial activity, and segment-related information, where appropriate
- *Other accompanying information*, which would include data on performance measures and forgone Federal revenues, on subjects such as tax burden and tax gaps, as appropriate for specific entities

These OMB-prescribed financial statements reflect summarized financial information contained in 2,000 ledger, subledger, and subsidiary accounts of the Federal Government's standard general ledger. In addition to providing meaningful reporting to citizens, the data in these entity-level financial statements form the basis for the consolidated financial statements of the U.S. government, which are also required by the CFO Act. Entity financial statements are rolled up by the Treasury Department when compiling the government-wide consolidated statements.

Currently, Federal entities are required to submit a quarterly financial statement package to OMB that consists of their balance sheet, statement of net cost, and statement of budgetary resources. A complete audited set of financial statements, including all required statements and note disclosures, is required at year-end. Included in this set are the financial statements that must, for each entity and for the government as a whole, annually undergo an independent audit.

## Balance Sheet (Statement of Financial Position)

The balance sheet is the component of the Federal financial statement that most closely resembles the corresponding statement of a commercial enterprise. The balance sheet presents the assets, liabilities, and net position of a Federal entity as of a specific time. The example presented in Exhibit 5.1 illustrates the prescribed format reflected in OMB Circular A-136. The key elements of a Federal Agency's balance sheet include:

- *Intragovernmental assets and liabilities* (i.e., assets and liabilities arising from transactions among Federal entities) being shown separately from assets and liabilities arising from transactions with non-Federal entities.
- *Net position* broken down between unexpended appropriation (the portion of an entity's appropriation represented by undelivered orders and unobligated balances) and cumulative results of operation<sup>3</sup> (the net results of operations since inception plus the cumulative amount of prior period adjustments; this includes the cumulative amount of donations and transfers of assets in and out without reimbursement). Unexpended appropriations and cumulative results of operations are further subdivided into earmarked funds (and referred to as funds from dedicated collections) and other. As defined by FASAB, funds from dedicated collections are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time.

### *Classifications in a Federal Balance Sheet*

An entity's *balance sheet* presents data as of a specific moment in time; a Federal balance sheet could present the financial position of a Federal entity as of the end of a month, quarter, or fiscal year.

Exhibit 5.1 is a generic example of the classified balance sheet required of Federal entities by OMB. OMB's form and content guidelines prescribes a classified balance sheet for Federal entities. Due to differing missions and programs of Federal entities, not all necessarily issue a balance sheet with this illustrated content or format.<sup>4</sup>

Congress is the ultimate determinant of what a Federal entity must report on and how. It is Congress that authorizes certain Federal entities to operate certain programs and not others. Congress designates which constituencies a Federal entity must serve and how (e.g., large corporations with big contracts; small businesses by subsidized loans and set-aside programs; nonprofit and educational institutions by grants; the young, old, hungry, and homeless by grants and direct subsidies; or others by loan and loan guarantee programs for education, health, economic development, natural disasters, etc.).

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<sup>3</sup> For a more detailed definition of earmarked funds, refer to SFFAS No. 27.

<sup>4</sup> Office of Management and Budget, *Financial Reporting Requirements*, Circular A-136 revised, effective for the fiscal year ending September 30, 2013.

<b>EXHIBIT 5.1 Balance Sheet</b>
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Department/Agency/Reporting entity  
**CONSOLIDATED BALANCE SHEET**  
 As of September 30, 2XXX (CY) and 2XXX (PY)  
 (in dollars/thousands/millions)

Assets (Note 2):	2XXX (CY)	2XXX (PY)
Intragovernmental:		
1. Fund balance with Treasury (Note 3)	\$ xxx	\$ xxx
2. Investments (Note 5)	xxx	xxx
3. Accounts receivable (Note 6)	xxx	xxx
4. Loans receivable	xxx	xxx
5. Other (Note 12)	xxx	xxx
6. Total intragovernmental	xxx	xxx
7. Cash and other monetary assets (Note 4)	xxx	xxx
8. Investments (Note 5)	xxx	xxx
9. Accounts receivable, net (Note 6)	xxx	xxx
10. Taxes receivable, net (Note 7)	xxx	xxx
11. Direct loan and loan guarantees, net (Note 8)	xxx	xxx
12. Inventory and related property, net (Note 9)	xxx	xxx
13. General property, plant and equipment, net (Note 10)	xxx	xxx
14. Other (Note 11)	<u>xxx</u>	<u>xxx</u>
15. Total assets	<u>\$ x,xxx</u>	<u>x,xxx</u>
16. Stewardship PP&E (Note 11)		
Liabilities (Note 13):		
Intragovernmental:		
17. Accounts payable	\$ xxx	\$ xxx
18. Debt (Note 13)	xxx	xxx
19. Other (Notes 15, 16, and 17)	xxx	xxx
20. Total intragovernmental	<u>xxx</u>	<u>xxx</u>
21. Accounts payable	xxx	xxx
22. Loan guarantee liability (Note 8)	xxx	xxx
23. Debt held by the public (Note 14)	xxx	xxx
24. Federal employee and veteran benefits (Note 15)	xxx	xxx
25. Environmental and disposal liabilities (Note 16)	xxx	xxx
26. Benefits due and payable	xxx	xxx
27. Other (Notes 15, 16, 17, 18 and 19)	<u>xxx</u>	<u>xxx</u>
28. Total liabilities	<u>x,xxx</u>	<u>x,xxx</u>
29. Commitments and contingencies (Note 20)		
Net position:		
30. Unexpended appropriations—earmarked funds (Note 21)	xxx	xxx
31. Unexpended appropriations—other funds	xxx	xxx
32. Cumulative results of operations—earmarked funds (Note 21)	xxx	xxx
33. Cumulative results of operations—other funds	xxx	xxx
34. Total net position	<u>\$ x,xxx</u>	<u>\$ x,xxx</u>
35. Total liabilities and net position	<u>\$ x,xxx</u>	<u>\$ x,xxx</u>

The accompanying notes are an integral part of these statements.



### ***Accounting for Assets***

*Assets* are defined as tangible or intangible items owned by the Federal Government that could have probable economic benefits that can be obtained or controlled by the Federal entity.<sup>5</sup> These assets include cash, investments, real and personal properties, and also claims of the Federal entity against non-Federal entities or parties (e.g., accounts receivable, interest receivable, and amounts due from Federal advances and advances or prepayments to these non-Federal entities or parties). With some exceptions, assets are initially recorded as purchased costs or donated values.

### ***Accounting for Liabilities***

FASAB and OMB define a Federal *liability* as a “probable and measurable future outflow of resources arising from past transactions or events.” The liabilities grouping of accounts include an enormity of transactions and events, such as accounts payables, end-of-period accrual liabilities, Federal commitments and guarantees legally assumed or entered into, contingencies, damages from litigious proceedings, and others. Liabilities are measured and recorded in a Federal entity’s accounts in the period incurred and removed from the accounts in the period liquidated or paid. Also, liabilities represent amounts owed and are not dependent upon receipt of an invoice or request for payment. Liabilities must be reported irrespective of whether Federal funds are available or authorized for their payment.

Federal liabilities arise in four ways:

1. Exchange transactions (i.e., for services rendered)
2. Government-related events
3. Government-acknowledged events (i.e., voluntary assumption of debts, risks, or costs of others)
4. Nonexchange transactions (i.e., debts and amounts due the sovereign government, as taxes)

Any advance payments and prepayments from other entities for goods or services yet to be delivered by a Federal entity must also be recorded as other current liabilities.

### ***Accounting for the Net Position of a Federal Entity***

*Net Federal or entity position* is defined by FASAB as the “unexpended appropriations and the cumulative result or residual balance” resulting from (1) the initial investment to commence a Federal operation; (2) the cumulative results of the operation’s revenues or

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<sup>5</sup> Federal Accounting Standards Advisory Board, *FASAB Handbook of Federal Accounting Standards and Other Pronouncements, As Amended* (June 2011).

resources and expenses; and (3) donations, collections, or transfers of funds or other property by or to a Federal entity, as permitted by Congress.

- *Unexpended appropriations* are appropriations not yet obligated or expended, and undelivered orders.
- *Cumulative results of operations* include amounts accumulated over the years by an entity from its financing sources less expenses and losses, including donated capital and transfers in the net investment of the government account and the entity's liabilities (for accrued leave, credit reform, and actuarial liabilities not covered by available budgetary resources).
- *Residual balance* is comprised of appropriated capital provided by Congress; invested capitalized assets or expended appropriations for purchased goods and property; or receivables due for loaned or advanced Federal monies. The net position investment could relate to a single appropriation, several appropriations, or other congressional budgetary authority accounts.

In addition to the information presented on the face of the balance sheet, certain information related to the assets and liabilities of a Federal entity is required to be disclosed in the notes to the financial statements, per the provisions of OMB Circular A-136. Some disclosure requirements unique to the Federal environment include these:

- *Nonentity assets.* Nonentity assets are those assets that are held by the entity but are not available to the entity. Examples of nonentity assets include customs duty receivables that the Customs Service collects for the U.S. government but do not have the authority to spend, the Federal income tax receivable that the Internal Revenue Service (IRS) collects, and the regulatory fees collected by the Federal Communications Commission. In each case, the Federal entity holding the asset does not possess the authority to spend the funds. Further disclosure is required to show intragovernmental nonentity assets. Also, the agency must provide other information needed to understand the nature of nonentity assets.
- *Fund balance with Treasury.* The composition of fund balance with Treasury (i.e., amounts representing trust, revolving, appropriated, and other fund types) is required to be disclosed along with the status of the fund balance (i.e., amounts unobligated and available, obligated and unavailable, disbursed or not yet disbursed).
- *Cash and other monetary assets.* The balance is required to be divided into cash, foreign currency, and other monetary assets (i.e., gold, special drawing rights, U.S. Reserves in the International Monetary Fund). In addition, the entity is required to disclose any restrictions on cash.
- *Investments.* The cost, unamortized premium or discount, amortization method, net investment, other adjustments, and market value of all material investments of a

Federal entity are required to be disclosed. In addition, any information relative to understanding the nature of reported investments, such as permanent impairments, should be disclosed.

- *Direct loans and loan guarantees.* Considerable additional disclosure is required for Federal Agencies subject to the provisions of the Federal Credit Reform Act. See SFFAS 2, *Accounting for Direct Loans and Loan Guarantees* as well as OMB Circular A-136 for discussion and formatting of the required disclosures.
- *Liabilities not covered by budgetary resources.* These are liabilities for which congressional action is needed before budgetary resources can be provided. These disclosures should report intragovernmental and other liabilities separately. The distinction between funded and unfunded liabilities is as follows:
  - Federally funded liabilities would be *liabilities covered by budgetary resources*. That is, the Federal entity has available to it congressionally approved expenditure authority, through an appropriation law or other budgetary or contract authority that permits the entity to recognize and pay these liabilities.
  - Federal unfunded liabilities would be those liabilities recognized by a Federal entity that are considered to be *liabilities not covered by budgetary resources*, as defined in the above paragraph. Payables and liabilities not covered by budgetary resources are unfunded and should be separately disclosed and segregated from payables or liabilities that are covered by budgetary resources.
- *Federal Employee and Veterans Benefits.* Entities that are responsible for administering pensions, retirement benefits, and other postemployment benefits should calculate and report these liabilities and related expenses in accordance with SFFAS 5, *Accounting for Liabilities of the Federal Government*.

In addition, the normal required disclosures under generally accepted accounting principles (GAAP) for areas such as accounts receivable, inventory, PP&E, debt, leases, and commitments and contingencies are also required for Federal entities.

### **Statement of Net Cost**

The statement of net cost is designed to separately show the components of the net cost of the reporting entity's operations for the period. The net cost of operations is the gross cost incurred less any exchange revenue earned from its activities. The gross cost of a program consists of the full costs of the outputs produced by the program, plus any nonproduction costs that can be identified and assigned to the program. Exchange revenue arises when a government entity provides goods or services to the public or another government entity for a price. *Exchange revenue* is synonymous with earned revenue. This statement should be presented in responsibility segments that align directly with the major goals and outputs described in the entity's strategic and performance plans, as required by the Government Performance and Results Act.

<b>EXHIBIT 5.2 Statement of Net Cost</b>
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Department/Agency/Reporting Entity		
STATEMENT OF NET COST		
For the years ended September 30, 2XXX (CY) and 2XXX (PY)		
(in dollars/thousands/millions)		
	<u>2XXX</u> (CY)	<u>2XXX</u> (PY)
Gross Program costs:		
Program A:		
Gross costs (Note 22)	\$ xxx	\$ xxx
Less: earned revenue	-xxx	-xxx
Net program costs:	\$ <u>xxx</u>	\$ <u>xxx</u>
Other Programs:		
Program B:	xxx	xxx
Program C:	xxx	xxx
Program D:	xxx	xxx
Program E:	xxx	xxx
Other programs:	xxx	xxx
Less: earned revenue	-xxx	-xxx
Net other program costs:	\$ <u>x,xxx</u>	\$ <u>x,xxx</u>
(Gain)/Loss on pension, ORB, or OPEB		
Assumption changes (Note 15)	\$ -xxx	\$ -xxx
Net program costs including		
Assumption changes:	\$ <u>x,xxx</u>	\$ <u>-x,xxx</u>
Cost not assigned to programs	xxx	xxx
Less: earned revenues not attributed to programs	-xxx	-xxx
Net cost of operations	\$ <u>x,xxx</u>	\$ <u>x,xxx</u>

The accompanying notes are an integral part of these statements.

In 1995, FASAB, in its recommended accounting standard related to entity and display, viewed the statement of net cost as specifically meeting the Federal reporting objective to “provide information that helps the reader determine the costs of providing specific programs and activities and the composition of, and changes in, these costs.”

The primary purpose of the statement of net cost is to display, in clear terms, the net cost (i.e., total costs less all revenues attributed to a program and permitted to be offset against program costs) by an entity’s suborganizations and of its programs and other costs (i.e., administrative and other costs not allocated to specific programs). Exhibit 5.2 is an illustration of the statement of net cost.

Occasionally, the structure and operations of an entity are so complex that in order to fully display the major programs and activities of all of their suborganizations, additional supporting schedules are required. These schedules should be presented in the notes to the financial statements. Other note disclosures required for the statement of net cost include:

- Intragovernmental cost
- Cost of stewardship property, plant, and equipment
- Stewardship assets acquired through transfer or donation
- Exchange revenue
- Gross cost and earned revenue by budget functional classification

### **Statement of Changes in Net Position**

The statement of changes in net position reports changes in the two components of a Federal entity's net position (cumulative results of operations and unexpended appropriations). The statement format was designed in a manner to show each component separately. See Exhibit 5.3.

The statement of changes in net position ties together several amounts from the other component statements of a Federal financial statement. Both components of net position are reflected as line items on the balance sheet. Budgetary appropriations received on the statement of changes in net position must agree with line 1 of the statement of budgetary resources. The "Other Financing Sources" section of the statement must agree with the statement of financing. The net cost of operations on the statement of changes in net position must agree to the statement of net cost.

The purpose of a Federal entity's statement of changes in net position is to identify all financing sources available or used by a Federal entity to support its net cost of operations and the net effect or change in the entity's financial position. As illustrated in Exhibit 5.3, these financial data are arrayed by the same organizational components and responsibility segments as appeared in the statement of net costs.

### ***Classifications of Financing Sources***

Since the purpose of this statement is to identify changes in the net position, or how an entity's costs were financed, OMB has prescribed specific data classifications to be used. These classifications must be identified, whether shown in a statement of changes in net position or combined with the statement of net cost.

- *Appropriation used* represents amounts of congressional budget authority, including all transfers of budget authority from other entities that may be used by Federal entities to finance mandated operations.
- *Nonexchange revenues* include all receipts of taxes and non-exchange revenues such as dedicated taxes, fines, and other revenues the Federal Government demands in its role as a sovereign power.

Once collected, these major funds then become monies to be appropriated by Congress. The collection function involves only a few Federal entities (e.g., the IRS for personal and business taxes; Customs Service for import fees and duties). These entities are not authorized to use all collections for their operations; rather they serve as collecting agencies

<b>EXHIBIT 5.3 Statement of Changes in Net Position</b>
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Department/Agency/Reporting Entity  
**STATEMENT OF CHANGES IN NET POSITION**  
 For the Year Ended September 30, 20X2 and 20X1  
 (in dollars/thousands/millions)

	FY 20XX (CY)			Consolidated Total
	Earmarked Funds	All Other Funds	Eliminations	
<b>Cumulative Results of Operations:</b>				
1. Beginning Balances	\$ xxx	\$ xxx	\$ xxx	\$ xxx
2. Adjustments				
2A. Changes in accounting principles	xxx	xxx	xxx	xxx
2B. Corrections of errors	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
3. Beginning balances, as adjusted	xxx	xxx	xxx	xxx
<b>Budgetary Financing Sources:</b>				
4. Other adjustments	xxx	xxx	xxx	xxx
5. Appropriations used	xxx	xxx	xxx	xxx
6. Nonexchange revenue	xxx	xxx	xxx	xxx
7. Donations and forfeitures of cash	xxx	xxx	xxx	xxx
8. Transfers in/out without reimbursement	xxx	xxx	xxx	xxx
9. Other	xxx	xxx	xxx	xxx
<b>Other Financing Sources:</b>				
10. Donations and forfeitures of property	xxx	xxx	xxx	xxx
11. Transfers in/out without reimbursement (+/-)	xxx	xxx	xxx	xxx
12. Imputed financing	xxx	xxx	xxx	xxx
13. Other	xxx	xxx	xxx	xxx
14. Total financing sources	xxx	xxx	xxx	xxx
15. Net cost of operations	xxx	xxx	xxx	xxx
16. Net change	xxx	xxx	xxx	xxx
<b>17. Cumulative Results of Operations</b>	<b>xxx</b>	<b>xxx</b>	<b>xxx</b>	<b>xxx</b>
<b>Unexpended Appropriations:</b>				
18. Beginning balance	xxx	xxx	xxx	xxx
19. Adjustments:				
19A. Changes in accounting principles	xxx	xxx	xxx	xxx
19B. Corrections of errors	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
20. Beginning balance, as adjusted	xxx	xxx	xxx	xxx
<b>Budgetary Financing Sources:</b>				
21. Appropriations received	xxx	xxx	xxx	xxx
22. Appropriations transferred in/out	xxx	xxx	xxx	xxx
23. Other adjustments	xxx	xxx	xxx	xxx
24. Appropriations used	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
25. Total budgetary financing sources	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
26. Total unexpended appropriations	xxx	xxx	xxx	xxx
27. Net position	xxx	xxx	xxx	xxx

The accompanying notes are an integral part of these statements.

Department/Agency/Reporting Entity  
 STATEMENT OF CHANGES IN NET POSITION  
 For the Year Ended September 30, 20X2 and 20X1  
 (in dollars/thousands/millions)

	FY 20XX (PY)			Consolidated Total
	Earmarked Funds	All Other Funds	Eliminations	
<b>Cumulative Results of Operations:</b>				
1. Beginning balances	\$ xxx	\$ xxx	\$ xxx	\$ xxx
2. Adjustments				
2A. Changes in accounting principles	xxx	xxx	xxx	xxx
2B. Corrections of errors	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
3. Beginning balances, as adjusted	xxx	xxx	xxx	xxx
<b>Budgetary Financing Sources:</b>				
4. Other adjustments	xxx	xxx	xxx	xxx
5. Appropriations used	xxx	xxx	xxx	xxx
6. Nonexchange revenue	xxx	xxx	xxx	xxx
7. Donations and forfeitures of cash	xxx	xxx	xxx	xxx
8. Transfers in/out without reimbursement	xxx	xxx	xxx	xxx
9. Other	xxx	xxx	xxx	xxx
<b>Other Financing Sources:</b>				
10. Donations and forfeitures of property	xxx	xxx	xxx	xxx
11. Transfers in/out without reimbursement (+/-)	xxx	xxx	xxx	xxx
12. Imputed financing	xxx	xxx	xxx	xxx
13. Other	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
14. Total financing sources	xxx	xxx	xxx	xxx
15. Net cost of operations	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
16. Net change	xxx	xxx	xxx	xxx
<b>17. Cumulative Results of Operations</b>	<b>xxx</b>	<b>xxx</b>	<b>xxx</b>	<b>xxx</b>
<b>Unexpended Appropriations:</b>				
18. Beginning Balance	xxx	xxx	xxx	xxx
19. Adjustments:				
19A. Changes in accounting principles	xxx	xxx	xxx	xxx
19B. Corrections of errors	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
20. Beginning balance, as adjusted	xxx	xxx	xxx	xxx
<b>Budgetary Financing Sources:</b>				
21. Appropriations received	xxx	xxx	xxx	xxx
22. Appropriations transferred in/out	xxx	xxx	xxx	xxx
23. Other adjustments	xxx	xxx	xxx	xxx
24. Appropriations used	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
25. Total budgetary financing sources	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
26. Total unexpended appropriations	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
27. Net position	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>

The accompanying notes are an integral part of these statements.

and custodians of cash received and turned over to the Treasury Department. (For these entities, a statement of custodial activities, discussed later, would be appropriate.)

For all other Federal entities, nonexchange revenues collected would be shown on this statement.

- *Donations* are monies and materials given by private persons and organizations to the Federal Government without receiving anything in exchange. Not all Federal entities are authorized to accept donations or contributions; specific authority must be provided by Congress.
- *Imputed financing sources* are costs incurred by a Federal entity that are financed by another Federal entity. This classification must include costs attributable to the reporting Federal entity's activities but that do not require a direct cash payment in the reporting period (e.g., interest cost associated with carrying inventory or investing in physical assets). For example, Congress provides a direct appropriation of funds to the central Office of Personnel Management to pay retirement and other post-retirement costs to former Federal employees, most of whom were employed by Federal entities other than OPM.
- *Transfers in* are amounts of cash or other capitalized assets received by one Federal entity from another Federal entity without reimbursement. *Transfers out* are amounts of cash or other capitalized assets provided by one Federal entity to another Federal entity without reimbursement. If exchange revenue, included in calculating an entity's net cost of operations, is transferred to the Treasury Department or another Federal entity, the amount transferred is recognized as a transfer out and not netted against the entity's cost of operations. If the cash or book value is not known for these transferred amounts, the recorded value is the estimated fair value of the asset at transfer date.
- *Cost of operations* must be the same amount as reported on the statement of net cost and on the entity's statement of changes in net position for the same fiscal period.
- *Prior-period adjustments* are corrections or adjustments to data reported for operations in a prior fiscal period. These adjustments are limited to the correction of errors and accounting changes having a retroactive effect that impacts the reported net position of the Federal entity. OMB does not require that statements of changes in net position of prior periods be restated for prior-period adjustments.
- *Unexpended appropriations and budgetary authority* will exist at the end of any fiscal period. The increase or decrease in this amount affects the net position of a Federal entity but does not affect the reported net cost for that period. These unexpended appropriation amounts may become the costs reported for some future period.
- *Ending balance (net position at the end of the period)* is equal to the total unexpended appropriations and the cumulative results of operations of the Federal entity and



would also be reported in the entity's statement of financial condition (i.e., the entity's balance sheet). The end-of-period balance becomes the beginning balance of unexpended appropriations for the next fiscal period.

The "Beginning Balances" section of the statement of changes in net position must agree to the amounts reported as net position on the prior years' balance sheets. The prior-period adjustment amounts would be limited to the items defined as prior period adjustments in SFFAS 21, *Reporting Corrections of Errors and Changes in Accounting Principles*.

The "Budgetary Financing Sources" section reflects financing sources and non-exchange revenue that are also budgetary resources, or adjustments to those resources as reported on the statement of budgetary resources and defined as such by OMB Circular A-11. The "Other Financing Sources" section reflects financing sources and nonexchange revenues that do not represent budgetary resources as reported on the statement of budgetary resources and as defined by OMB Circular A-11.

Effective for fiscal year 2006, SFFAS 27, *Identifying and Reporting Funds from Dedicated Collections*, requires Federal component entities to show earmarked nonexchange revenue and other financing sources, including appropriations and net costs of operations, separately on the statement of changes in net position. It should be noted here that this statement does not use the term "earmarked" as it is sometimes used to refer to set-asides of appropriations for specific purposes, but rather, the Board intends that the term *earmarked fund* be applied based on the substance of the statute and consistent with the three criteria set forth in the standard.

### **Statement of Budgetary Resources**

The statement of budgetary resources and related disclosures provide information regarding how budgetary resources were made available and the status of those resources at the end of the reporting period. The statement of budgetary resources is the statement most unique to the Federal entity. It is the only statement prepared exclusively from the entity's budgetary general ledger and in accordance with budgetary accounting rules that have been incorporated into GAAP for Federal entities.

The statement of budgetary resources is particularly meaningful since data are provided on how a Federal entity obtained its budgetary resources and the status or remaining balances of these resources at the end of the reporting period. This statement, illustrated in Exhibit 5.4, is prepared by Federal entities whose financing comes wholly or partially from congressional appropriations and borrowing, spending, and contract authority.

The basis for accounting and reporting on this statement is prescribed by OMB in its long-standing and regularly updated Circular A-11, *Preparation, Submission and Execution of the Budget*. The statement of budgetary resources is required to be classified into four major sections or groupings.

<b>EXHIBIT 5.4 Statement of Budgetary Resources</b>
---

Department/Agency/Reporting Entity  
**STATEMENT OF BUDGETARY RESOURCES**  
 For the Years Ended September 30, 2XXX (CY) and 2XXX (PY)  
 (in dollars/thousands/millions)

	2XXX (CY)	2XXX (CY)	2XXX (PY)	2XXX (PY)
	Non-Budgetary Credit Reform Financing		Non-Budgetary Credit Reform Financing	
	Budgetary	Account	Budgetary	Account
<b>Budgetary Resources:</b>				
1000 Unobligated balance brought forward, Oct 1	\$ xxx	\$ xxx	\$ xxx	\$ xxx
1020 Adjustment to unobligated balance brought forward, Oct 1 (+ or -) (Note 28)	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
1020.5* Unobligated balance brought forward, Oct. 1, as adjusted	xxx	xxx	xxx	xxx
1021 Recoveries of prior year unpaid obligations	xxx	xxx	xxx	xxx
1043* Other changes in unobligated balance (+ or -)	xxx	xxx	xxx	xxx
1051* Unobligated balance from prior year budget authority	xxx	xxx	xxx	xxx
1290* Appropriations (discretionary and mandatory)	xxx	xxx	xxx	xxx
1490* Borrowing authority (discretionary and mandatory)	xxx	xxx	xxx	xxx
1690* Contract authority (discretionary and mandatory)	xxx	xxx	xxx	xxx
1890* Spending authority from offsetting collections (discretionary and mandatory)	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
1910* Total budgetary resources	\$ xxx	\$ xxx	\$ xxx	\$ xxx
<b>Status of Budgetary Resources:</b>				
2190 Obligations incurred (Note 31)	\$ xxx	\$ xxx	\$ xxx	\$ xxx
2204* Apportioned	xxx	xxx	xxx	xxx
2304* Exempt from apportionment	xxx	xxx	xxx	xxx
2404* Unapportioned	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
2490 Total unobligated balance, end of year	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
2500 Total budgetary resources	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>
<b>Change in Obligated Balance:</b>				
3000 Unpaid obligations, brought forward, Oct. 1	\$ xxx	\$ xxx	\$ xxx	\$ xxx
3006* Adjustments to unpaid obligations, start of year (+ or -) (Note 28)	xxx	xxx	xxx	xxx
3012* Obligations incurred	xxx	xxx	xxx	xxx
3020 Outlays (gross) (-)	xxx	xxx	xxx	xxx
3032* Actual transfers, unpaid obligations (net) (+ or -)	xxx	xxx	xxx	xxx
3042* Recoveries of prior year unpaid obligations (-)	xxx	xxx	xxx	xxx
3050 Unpaid obligations, end of year	xxx	xxx	xxx	xxx
<b>Uncollected Payments:</b>				
3060 Uncollected pymts, Fed sources, brought forward, Oct. 2 (-)	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
3066* Adjustments to uncollected pymts, Fed sources, start of year (+ or -) (Note 28)	xxx	xxx	xxx	xxx

3072* Change in uncollected pymts, Fed sources (+ or -)	xxx	xxx	xxx	xxx
3082* Actual transfers, uncollected pymts, Fed sources (+ or -)	xxx	xxx	xxx	xxx
3090 Uncollected pymts, Fed sources, end of year (-)	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
Memorandum (non-add) entries				
3100 Obligated balance, start of year (+ or -)	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>
3200 Obligated balance, end of year (+ or -)	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>
<b>Budget Authority and Outlays, Net:</b>				
4175* Budget authority, gross (discretionary and mandatory)	\$ xxx	\$ xxx	\$ xxx	\$ xxx
4177* Actual offsetting collections (discretionary and mandatory) (-)	xxx	xxx	xxx	xxx
4178* Change in uncollected customer payments from Federal sources (discretionary and mandatory) (+ or -)	xxx	xxx	xxx	xxx
4179* <sup>†</sup> Anticipated offsetting collections (discretionary and mandatory) (+ or -)	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>
4180 Budget authority, net (discretionary and mandatory)	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>
4185* Outlays, gross (discretionary and mandatory)	\$ xxx	\$ xxx	\$ xxx	\$ xxx
4187* Actual offsetting collections (discretionary and mandatory)	xxx	xxx	xxx	xxx
4190 Outlays, net (discretionary and mandatory)	xxx	xxx	xxx	xxx
4200* Distributed offsetting receipts (-)	xxx	xxx	xxx	xxx
4210 Agency outlays, net (discretionary and mandatory)	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>	<u>\$ xxx</u>

\*Represents a line number that is unique to SBR. Further information on the descriptions and composition of these lines can be found in OMB Circular A-11, Appendix F.

<sup>†</sup>Not applicable to the fourth quarter.

The accompanying notes are an integral part of these statements.

1. The “Budgetary Resources” section presents the total obligational and non-budgetary resources (generally from congressional appropriations and budgetary and contract authority) under the stewardship of a Federal entity. These accountable resources could include new budget authority, unobligated balances at the beginning of a period and those transferred in and out during the period, recoveries of prior-year obligations, and any adjustments made to an entity’s budgetary resources. The calculated total for budgetary resources is the total amount made available to the Federal entity for the fiscal period.
2. The “Status of Budgetary Resources” section of the statement provides an analysis of the status of budgetary resources by such specific components as obligations incurred, unobligated balances of available budget authority, and unobligated balances that are unavailable except to adjust or liquidate obligations charged to a prior year’s appropriations. The total of this section, “Total Status of Budgetary Resources,” is equal to the budgetary resources still available to the Federal entity as of the reporting date.
3. The “Change in Obligated Balance” section displays the change in obligated balances during the reporting period.

4. The “Budget Authority and Outlays, Net” section shows gross budget authority and the net outlays or cash disbursements by a Federal entity for the fiscal period. Budget authority consists of appropriations, borrowing authority, contract authority, and spending authority from offsetting collections and reduced by the offsets displayed in Exhibit 5.4. Net outlays would be the total of disbursement requests made to the Treasury Department for the period reduced by actual offsetting collections.

Data appearing on the statement of budgetary resources is, in condensed form, the same data reported by Federal entities to OMB on the report of budget execution (i.e., the government’s Standard Form [SF] 133, *Report on Budget Execution and Budgetary Resources*) pursuant to OMB Circular A-11. Also, these data are reported government-wide in the Treasury Department’s monthly Treasury statement and its annual report, as well as in the President’s budget request annually submitted to Congress.

An important consideration for preparers and auditors of the statement of budgetary resources is that the statement should be consistent with the budget execution information reported in SF-133 and with information reported in the Budget of the United States Government for the entity. The statement of budgetary resources is an agency-wide report that aggregates account-level information reported in the SF-133. Any material differences between the information reported must be disclosed in the notes to the financial statements.

Consistent with the SF-133 and the general ledger for budgetary accounting, the statement of budgetary resources tracks budgetary resources and their status independently. The total of budgetary resources and the status of budgetary resources must always be in balance, just as total assets must always equal total liabilities plus net position. The “Budgetary Resources” section presents the total budgetary resources available to the reporting entity. Budgetary resources include new budget authority, unobligated balances at the beginning of the period, spending authority from offsetting collections, recoveries of prior-year obligations, and any adjustments to these resources. The “Status of Budgetary Resources” section displays information about where in the budgetary process the resources are (i.e., their status). It consists of:

- Obligations incurred.
- Unobligated balances at the end of the period that remain available.
- Unobligated balances at the end of the period that are unavailable.
- Unobligated balance at the end of the period that is not available, except to adjust or liquidate prior-year obligations.

The final section of the statement of budgetary resources displays the relationship between obligations incurred and outlays during the reporting period. Outlays consist of disbursements net of offsetting collections. The net outlays reported on the statement of budgetary resources must agree with the total outlays reported in the budget of the United

States, the aggregate outlays reported on the year-end SF-133 for all budget accounts, and the net total of all disbursements and collections reported to the U.S. Treasury on a monthly basis on the statement of transactions (SF-224) for the reporting period.

Additional financial statement disclosure related to the statement of budgetary resources includes:

- Apportionment categories of obligations incurred. The reporting entity is required to disclose the amount of direct and reimbursable obligations incurred against amounts apportioned under Category A, B, and exempt from apportionment. The disclosure must agree with the aggregate information on the entity's year-end SF-133 and lines 8a and 8b of the statement of budgetary resources. The apportionment categories are determined in accordance with the provisions of OMB Circular A-11.
- Adjustments to beginning balances of budgetary resources.
- Legal arrangements affecting use of unobligated balances.
- Explanation of differences between the statement of budgetary resources and the budget of the U.S. government. Differences between the statement of budgetary resources and the amounts reported in the budget do not always indicate a reporting error. Legitimate reasons for such differences can exist. The note disclosure should list and explain the reasons for all differences.

### **Statement of Custodial Activity**

The statement of custodial activity is not required for all Federal entities, only for those agencies that collect nonexchange revenue for the general fund of the Treasury, a trust fund, or other recipient entities. An additional exception to the preparation of the statement of custodial activity is made for entities whose custodial collections are immaterial and incidental to their primary mission. In these instances, the collections are identified in the footnotes to the entity's financial statements. In addition, entities preparing a statement of custodial activity for nonexchange revenue should disclose:

- Basis of accounting.
- Factors affecting the collectability and timing of the nonexchange revenue.
- Cash collections and refunds.

Agencies required to prepare a statement of custodial activity include the IRS, U.S. Customs and Border Protection, and the Federal Communications Commission.

To account for custodial activity, the collecting entities do not recognize as revenue those collections that have been, or should be, transferred to others as revenue. Instead, the collection and disbursement of funds is reported on the statement of custodial activity. If some of the nonexchange revenue is transferred to others and some is retained by the collecting entity to offset the cost of collections, both amounts are reported on the statement of custodial activity, and the amounts retained are also reported on the

<b>EXHIBIT 5.5 Statement of Custodial Activity</b>
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Department/Agency/Reporting Entity			
STATEMENT OF CUSTODIAL ACTIVITY			
For the Years Ended September 30, 2XXX (CY) and 2XXX (PY)			
(in dollars/thousands/millions)		2XXX	2XXX
<b>Revenue Activity:</b>			
Sources of Cash Collections:			
1. Individual Income and FICA/SECA Taxes	\$ xxx		xxx
2. Corporate Income Taxes	xxx		xxx
3. Excise taxes	xxx		xxx
4. Estate and Gift Taxes	<u>xxx</u>		<u>xxx</u>
5. Federal Unemployment Taxes	xxx		xxx
6. Customs Duties	xxx		xxx
7. Miscellaneous	<u>xxx</u>		<u>xxx</u>
8. Total Cash Collections	x,xxx		x,xxx
9. Accrual Adjustments (+/-)	<u>xxx</u>		<u>xxx</u>
<b>10. Total Custodial Revenue</b>		x,xxx	x,xxx
<b>Disposition of Collections:</b>			
11. Transferred to Others (by Recipient):			
Recipient A	xxx		xxx
Recipient B	xxx		xxx
Recipient C	xxx		xxx
12. (Increase)/Decrease in Amounts Yet to Be Transferred (+/-)	xxx		xxx
13. Refunds and Other Payments	xxx		xxx
14. Retained by Reporting Entity	xxx		xxx
<b>15. Total Disposition of Collections</b>	<u>xxx</u>		<u>xxx</u>
<b>16. Net Custodial Activity</b>		<u>\$ 0</u>	<u>\$ 0</u>

The accompanying notes are an integral part of these statements.

statement of net cost. See Exhibit 5.5. In all cases, the “Total Sources of Collections” section (total revenue) must equal the “Total of the Disposition of Collections” section (total disposition of revenue). The net custodial activity must always be zero.

These requirements are described in SFFAS 7, *Accounting for Revenue and Other Financing Sources*.

### Statement of Social Insurance and Statement of Changes in Social Insurance Amounts

Like the statement of custodial activity, not all agencies are required to report a an SOSI (see Exhibit 5.6) and an SCSIA. An SOSI is required for these programs:<sup>6</sup>

<sup>6</sup> See SFFAS 17, *Accounting for Social Insurance*, and SFFAS 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*.

<b>EXHIBIT 5.6 Illustrative Statement of Social Insurance</b>
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75-Year Projection as of January 1, 200X  
(dollars in trillions)

Effective Prior to FY 2011

	2010	2009	2008	2007	2006
<i>Actuarial present value of future benefits payments paid during the 75-year projection period to or on behalf of:</i>					
1. Current participants who have not yet attained retirement age	\$ xxx	xxx	xxx	xxx	xxx
1A. OASDI	xxx	xxx	xxx	xxx	xxx
1B. HI	xxx	xxx	xxx	xxx	xxx
1C. SMI	xxx	xxx	xxx	xxx	xxx
1D. Other	xxx	xxx	xxx	xxx	xxx
2. Current participants who have attained retirement age	\$ xxx	xxx	xxx	xxx	xxx
2A. OASDI	xxx	xxx	xxx	xxx	xxx
2B. HI	xxx	xxx	xxx	xxx	xxx
2C. SMI	xxx	xxx	xxx	xxx	xxx
2D. Other	xxx	xxx	xxx	xxx	xxx
3. Those expected to become participants (i.e.: new entrants)	\$ xxx	xxx	xxx	xxx	xxx
3A. OASDI	xxx	xxx	xxx	xxx	xxx
3B. HI	xxx	xxx	xxx	xxx	xxx
3C. SMI	xxx	xxx	xxx	xxx	xxx
3D. Other	xxx	xxx	xxx	xxx	xxx
4. Subtotal-benefit payments for the 75-year projection period	\$ xxx	xxx	xxx	xxx	xxx
<i>Less the actuarial present value of future contributions and tax income received during the 75-year projection period from or on behalf of:</i>					
Current participants who have not yet attained retirement age	\$ xxx	xxx	xxx	xxx	xxx
5A. OASDI	xxx	xxx	xxx	xxx	xxx
5B. HI	xxx	xxx	xxx	xxx	xxx
5C. SMI	xxx	xxx	xxx	xxx	xxx
5D. Other	xxx	xxx	xxx	xxx	xxx
5. Current participants who have attained retirement age	\$ xxx	xxx	xxx	xxx	xxx
6A. OASDI	xxx	xxx	xxx	xxx	xxx
6B. HI	xxx	xxx	xxx	xxx	xxx
6C. SMI	xxx	xxx	xxx	xxx	xxx
6D. Other	xxx	xxx	xxx	xxx	xxx

- Old-Age, Survivors, and Disability Insurance (OASDI or Social Security)
- Hospital insurance (HI) and supplementary medical insurance (SMI), collectively known as Medicare
- Railroad retirement benefits
- Black lung benefits

These programs are housed in the agencies listed next.

- The Social Security Administration (SSA) administers the Old-Age, Survivors, and Disability Insurance (OASDI, or the Social Security program).
- The Centers for Medicare and Medicaid Services (CMS) as housed in the Health and Human Services (HHS) administers HI and SMI, collectively known as the Medicare program.
- The Railroad Retirement Board administers the railroad retirement benefits program.
- The Department of Labor administers the black lung benefits program.

The programs collectively are known as social insurance. The SOSI presents the actuarial present value of two figures:

1. Contributions and income to the program
2. Scheduled expenditures
3. Difference between figures 1 and 2

The SOSI must include a summary section that details assets that are held by the programs and the total unfunded obligation to date of the program as of the date of the reporting period. Entities required to present a SOSI must also present a SCSIA.

The purpose of the SOSI is to present the present value position of the funding of the program. The point of the SCSIA is to detail the line item changes by amount to the total funded or unfunded position over the last reporting period.

SFFAS 17, *Accounting for Social Insurance*; SFFAS 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*; SFFAS 26, *Presentation of Significant Assumptions for the Statement of Social Insurance: Amending SFFAS 25*; and SFFAS 37, *Social Insurance: Additional Requirements for Management's Discussion and Analysis and Basic Financial Statements* provide further detailed information about these statements.

### **Management's Discussion and Analysis**

Every agency's general purpose financial report must include a section devoted to an MD&A of the financial statements and related information. The MD&A section is designed to help readers better understand the entity's financial position and operating



results and to answer questions more directly related to a Federal entity's activities. Examples include:

- What is the entity's financial position and condition, and how did these occur?
- What were the significant variations from prior years, from the budget, from performance plans in addition to the budget?
- What is the potential effect of these factors, of changed circumstances, and of expected future trends?
- Will future financial position, condition, and results, as reflected in future financial statements, probably be different from this year's, and if yes, why?
- Are the systems of accounting and internal administrative controls adequate to ensure transactions are executed in accordance with budgetary and financial laws, assets are properly acquired and used, and performance measurement information is adequately supported?

The content of the MD&A is the responsibility of management. Its preparation should be a joint effort of both the chief financial officer and the program offices. The MD&A should be a fair and balanced presentation of information. It should include both positive and negative performance information, as necessary, to accurately portray the results of the agency. The information presented should be consistent with information presented in the performance plans and reports and the budget information. The auditor will not opine on the information presented in the MD&A, but certain limited procedures need to be performed. The procedures consist principally of inquiries of the agency's management regarding the methods of measurement and presentation of the information.

In 1998, FASAB recommended that the MD&A be treated as required supplementary information to Federal financial statements.<sup>7</sup> FASAB desired that the MD&A section of Federal financial statements section address an entity's:

- Mission and organizational structure.
- Performance goals and results.
- Financial statements.
- Systems and controls.
- Possible future effect on the entity's current demands, risks, uncertainties, events, conditions, and trends.

Current revisions of the guidance can be found in OMB Circular A-136.

FASAB states that the subjects in the MD&A could be based on information in other sections of the entity's general-purpose financial report or other reports that may be separate from the general-purpose financial report.

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<sup>7</sup> FASAB, *Concepts for Management's Discussion and Analysis*, November 1998.

### Required Supplementary Stewardship Information

Some Federal entities are entrusted with responsibilities for stewardship assets. These assets include:

- Stewardship PP&E (e.g., heritage assets—monuments, memorials, historical, cultural); mission PP&E (defense and space); and stewardship land (not for, or in connection with, general PP&E).
- Stewardship investments.
- Other stewardship responsibilities.

The reporting and disclosure of these assets may be in terms of physical units rather than cost, fair value, or other monetary values.

## GOVERNMENT-WIDE FINANCIAL STATEMENTS

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In spring 1998, the first consolidated and audited financial statements were issued for the U.S. government covering its fiscal year ended September 30, 1997. Robert Rubin, Secretary of the Treasury at the time, in the introduction to the 1997 Consolidated Financial Statements of the United States Government, wrote “never before has the United States Government attempted to assemble comprehensive financial statements covering all of its myriad activities and to subject those financial statements to an audit.”

### Format of Consolidated U.S. Statements

The consolidated government-wide financial statements differ somewhat from those prescribed and used by individual Federal entities in order to reflect the different reporting perspective for the entire government. The 2011 government-wide consolidated statements were comprised of these items:

- A message from the Secretary of the Treasury
- A Citizen’s Guide Summary of the financial report
- An MD&A section
- A disclaimer of audit opinion on the government-wide consolidated financial statements
- A report on internal controls
- A report on compliance with laws and regulations related to financial reporting
- Other information transmitted by GAO
- A consolidated statement of net cost for the U.S. government
- A consolidated statement of changes in net position for the U.S. government
- Reconciliations of net operating cost and unified budget deficit
- Statements of changes in cash balance from unified budget deficit and other activities

- A consolidated balance sheet for the U.S. government
- A consolidated statement of social insurance
- A consolidated statement of changes in social insurance amounts
- Notes to these financial statements
- A consolidated supplemental information for the U.S. government
- A consolidated stewardship reporting for the U.S. government

### **Content of Consolidated U.S. Statements**

As stated in Note 1 of the Summary of Significant Accounting Policies to the 2012 financial statements of the U.S. government, the consolidated financial statements of the United States generally include the financial activities of the executive, legislative, and judiciary branches, with the following exceptions (or deviations from GAAP):

- The Senate and the House of Representatives report on the cash basis.
- The judiciary branch reports on a limited basis (this branch is not required by law to submit financial statements to the Department of the Treasury) and what is reported is reported on the cash basis.
- Government-sponsored enterprises (i.e., Fannie Mae, Freddie Mac) are not included.
- Entities with activities not included in the Federal budget's total are also excluded. Examples include the Board of Governors of the Federal Reserve and the Thrift Savings Fund.

### **Basis of Accounting for U.S. Statements**

The consolidated financial statements are prepared in accordance with the form and content guidance specified by OMB that incorporates the recommendations of the FASAB. Under this basis of accounting, expenses are recognized when incurred, and nonexchange revenues are recognized on a modified cash basis. Cash remittances are recognized when received, and any related receivables are recognized when measurable and legally collectible by the Federal Government. Exchange revenues are recognized when earned.

### **Financial Reporting Checklist**

In performing the audit of a Federal entity, the auditor should complete, or have completed by the auditee, the Government Accountability Office/President's Council on Integrity and Efficiency's *Financial Audit Manual Checklist for Reports Prepared Under the CFO Act*. The checklist has been incorporated in GAO's *Financial Audit Manual* (Section 2020).



## **PART III**

# **AUDITING IN THE FEDERAL GOVERNMENT**



# 6 EVOLVING GUIDANCE

## ***Recent Developments in Auditing Standards***

Over the last six and a half years, the auditing profession has seen an unprecedented number of new and revised directives by virtually every agency and/or independent body responsible for the issuance of auditing standards and/or related guidance. A partial listing of such changes follows.

- Since December 2005, the American Institute of Certified Public Accountants (AICPA) has issued 24 new Statements on Auditing Standards (SASs), including an unprecedented 13 new SASs through December 2006. In addition, with regard to attestation engagement, an area of ever-growing importance to Federal auditors, the AICPA added five Statements on Standards for Attestation Engagements (SSAEs), including a major change to reporting on controls at a service organization, a subject previously covered by SASs.
- The Government Accountability Office (GAO) has issued two revised versions of its *Government Auditing Standards* (Yellow Book) as well as revisions to its *Financial Audit Manual (FAM)* and *Federal Information Systems Controls Audit Manual (FISCAM)* guidance.
- The Office of Management and Budget (OMB) has issued two audit requirements for Federal financial statements bulletins (06-03 and 07-04) plus a 2008 revision to the current OMB Audit Requirements for Federal Financial Statements (Bulletin 07-04). Although it was issued in 2004, the revised OMB Circular A-123, *Management's Responsibility for Internal Control* (including Appendix A), became effective during fiscal year (FY) 2006.
- Even the Committee of Sponsoring Organizations (COSO) has issued a proposed revision (dated November 2011) to its internal control *Framework*, which had remained unchanged since its original issuance in 1992.
- Finally (and of very limited impact in the Federal accounting/auditing arena), the Public Company Accounting Oversight Board (PCAOB) has issued 11 new standards.

The Sarbanes-Oxley Act (SOX) and PCAOB, along with a number of other lesser-known initiatives, are clearly the Federal Government's response to the financial scandals at the turn of the millennium. Along these same lines, we believe that a good number of

recent AICPA audit standards (and particularly the risk assessment standards addressed by SAS 104 to 111) are evidence of the profession's commitment to prevent future scandals and in essence minimize the risk of future embarrassment.

There is no argument that SOX, PCAOB, and the December 2005 to December 2006 risk assessment guidance affected Federal financial management in general and Federal auditing in particular, resulting in numerous changes and revisions to GAO and OMB guidance. It is hard to imagine any competent auditor objecting to or being at odds with the revised guidance. But how much has really changed? Beyond the introduction of changes in technical terms, how significant were the changes to Federal audit guidance? In the pages that follow, we discuss the risk assessment standards and certain changes to Federal audit guidance.

We hope this chapter helps the reader determine whether the revised guidance has resulted in a new paradigm or simply in the codification of commonsense auditing.

## 2006 STANDARDS

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As noted, December 2005 through December 2006 saw an unprecedented number (13) of new SASs (the 2006 standards), rivaled only by the 12 pronouncements issued during a similar 13-month period from April 1988 through April 1989.

Not surprisingly, these unusual outputs both occurred at a time when the audit profession was undergoing significant criticism and public embarrassment due to the savings and loan crisis in the mid-1980s and the Enron, WorldCom, and other financial scandals that took place at the beginning of the century.

A listing of the AICPA's 2006 SASs follows.

<i>SAS No.</i>	<i>Title</i>
102	Defining Professional Requirements in Statements on Auditing Standards
103	Audit Documentation
104	Amendment to Statement on Auditing Standards No. 1: Codification of Auditing Standards and Procedures (Due Professional Care in the Performance of Work)
105	Amendment to Statement on Auditing Standards No. 95: Generally Accepted Auditing Standards
106	Audit Evidence
107	Audit Risk and Materiality in Conducting an Audit
108	Planning and Supervision
109	Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements
110	Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained
111	Amendment to Statement on Auditing Standards No. 39: Audit Sampling
112	Communicating Internal Control Related Matters Identified in an Audit
113	Omnibus 2006
114	The Auditor's Communication with Those Charged with Governance



This section provides a brief overview of these standards and considers the impact of these standards on generally accepted government auditing standards (GAGAS) and related GAO and OMB guidance.

**SAS 102: Setting the Stage for the Risk Assessment Standards (SASs 104–111):  
Thou Shall . . .**

SAS 102, *Defining Professional Requirements in Statements on Auditing Standards*, clarifies the meaning of two terms, *must* and *should*, and in the case of the latter casts in stone the concept that *should* really means *must* except under exceptional circumstances. In this connection, the SAS identifies two types of requirements:

1. *Unconditional requirements.* This requirement is indicated by the word *must* or *is required*. There is no way around this procedure. If unable to perform or complete a “must” procedure, the auditor is required to disclaim or possibly (based on materiality) qualify his or her opinion.
2. *Presumptively mandatory requirement.* This requirement is indicated by the word *should*. There is a presumption that the procedure is required unless the auditor can justify the execution of alternatives procedures in lieu of the “should” requirement. This must be carefully documented as required by SAS 103.

The SAS also discusses other procedures typically associated with the terms *may*, *might*, and *could*. These terms identify suggested procedures and not mandatory requirements.

**Impact on GAGAS**

Experienced government auditors should be very familiar with the requirement to follow a risk-based audit approach. The use of very similar terms has been part of GAGAS for a long time and predates the issuance of SAS 102. The next GAGAS requirement is taken from GAO’s *FAM* Section 110.28:

The following terms are used throughout the *FAM* to describe the degree of compliance with the GAGAS standard or policy:

- **Must:** Compliance is mandatory when the circumstances exist to which the standard or policy applies. Most “musts” come directly from professional auditing standards where the auditor’s failure to perform means the auditor will not be able to express an unqualified opinion on the entity’s financial statements.
- **Should:** Compliance is expected when the circumstances exist to which the standard or policy applies, unless there is a reasonable basis for the departure. The auditor must document any such departure and the basis for it. The documentation should describe how the alternative procedures performed in

the circumstances were sufficient to achieve the objectives of the standard or policy and should be approved by the reviewer.

- **Generally should:** Although **optional**, compliance with this policy is strongly encouraged. The auditor may discuss any departure with the assistant director, but need not document compliance.
- **May:** Compliance with this policy or procedure is **optional**. The auditor need not document compliance. Situations can arise where the auditor is unable to or decides not to perform a procedure. Frequently, this is caused by missing, incomplete, or erroneous information. If it is decided that this is a key decision, the auditor should document why the procedure was not performed. When auditors plan to deviate from a standard or policy expressed by a “should,” they should determine the needs of, and consult in a timely manner with, other auditors who plan to use their work. This is necessary to provide an opportunity for other auditors to review the documentation explaining these decisions.

A footnote to *FAM*'s Section 110.28 states:

Similar to the AICPA auditing standards, if the *FAM* states that a procedure or action is one that the auditor “should consider,” determining whether to perform the procedure or action is required; however, performing the procedure or action is not. Because this is a “should,” the auditor should document any reasons for not performing this procedure and the alternative procedures performed to meet the objective. When the *FAM* lists factors that the auditor should evaluate when making a judgment, the auditor is expected to use these factors to make an informed judgment. However, the auditor may also consider other factors.

Clearly, SAS 102 does not impose new requirements on auditors of Federal financial statements.

### ***Practical Considerations***

It is important to consider that the absence of a need to comply with an unconditional requirement may not relieve the auditor from documenting the execution of the requirement. This seemingly contradictory statement is best illustrated by the requirement that the auditor assess the likelihood of financial statement presentation fraud in connection with revenues. This is very straightforward. However, what if the entity has no revenue (a frequent occurrence with Federal entities)? The risk-free approach is to state in the audit documentation that the auditor considered the requirement, but since the entity did not generate revenues, no audit procedures were executed. It is safe to say that tacit practices are no longer a good idea in connection with auditing documentation.

Regarding presumptively mandatory requirements, professional integrity/good conscience is of paramount importance in making the decision whether to depart from this

type of requirement. However, from a practical point of view, the auditor should also consider the likelihood a peer reviewer would agree. Our practical advice is to execute the procedure if at all possible.

**SAS 103: Setting the Stage for the Risk Assessment Standards (SASs 104–111): Can Anyone Follow What You Are Doing? and It’s Not Over Until It’s Over**

SAS 103, *Audit Documentation*, introduced two major changes:

1. Documentation requirements were expanded/tightened and the concept that an “experienced auditor” with no firsthand knowledge of the auditee (but capable of performing the work being reviewed) must be able to follow and understand the audit documentation contained in the working papers, including the reasons for the procedures and the conclusions reached, was introduced.
2. The requirements for determining the date of the auditor’s report was tightened and the requirements/definitions of the form content and extent of audit working papers were expanded.

Prior to SAS 103, the concept of being able to understand the working papers did not mention “experienced auditors” but revolved around “members of the engagement team.” That is, the need for a third party to be able to follow the working papers was not explicitly stated.

The concept of “experienced auditor,” however, is not new to government auditing. The following quote from an early version (1994) of GAO’s Yellow Book clearly points the difference between GAGAS and pre-SAS 103 GAAS:

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. (Paragraph 4.35)

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. (Paragraph 4.36)

The current version (2011) of GAO’s Yellow Book recognizes the adoption of the “experienced auditor” concept by the AICPA and drops the old language. Although the 2011 version still expands on the documentation requirements under GAGAS,

the introduction of the “experienced auditor” language and the expansion of working paper requirements bring the GAAS and GAGAS standards significantly closer than they were in the past.

As noted, a second significant change deals with the dating of the auditor’s report. Prior to the issuance of SAS 103, the date of the auditor’s report generally coincided with the completion of fieldwork. Under the old definition, the standard allowed for gaps in the required documentation including supervisory reviews (which presumably were in the process of being closed) to exist at the time of the auditor’s report. SAS 103 changes this by defining the report date as the date when all required data to support an opinion (including supervisory review) has been obtained. Routine closing procedures, such as final working paper assembly, completion of checklists, and so on, can still be performed after the report date.

### **SAS 104 through SAS 111: The Risk Assessment Standards: Shouldn’t We Have Been Doing This All Along?**

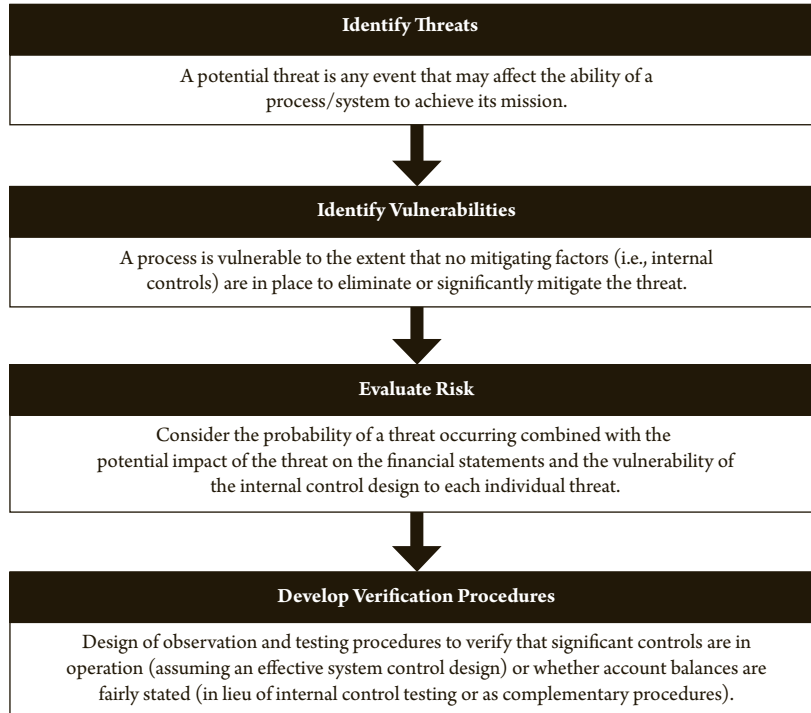
Issued in March 2007, SAS 104 through 111 resulted in significant changes to the audit process.<sup>1</sup> These standards:

- Require a more in-depth understanding of the entity (including its internal control) and identify a rigorous set of information-gathering procedures (“risk assessment procedures”). These standards significantly increase the auditor’s scope in connection with understanding the auditee’s “business.” Such an understanding is essential to the identification of potential threats, mitigating factors, vulnerabilities, and expected or assessed risk.
- With the required increased understanding of the entity, the auditor is better equipped to assess the risks of material misstatement of the financial statements. The revised standards provide for the risk assessment to be performed at two levels: the financial statement level and the relevant assertion level.
- Enable the auditor to improve the link between the assessed risks and the related procedures or tests (whether internal control or substantive) by emphasizing threats (e.g., what could happen), mitigating factors (e.g., internal control and potential dollar exposure or materiality), vulnerabilities (the impact of controls on the likelihood of a threat occurring), and expected risk (what is likely to happen based on the evaluation of threats, mitigating factors, and the potential financial impact of the vulnerability). As such, the standards are designed to avoid the execution of audits by rote based on what was done in the past as opposed to based on current conditions.

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<sup>1</sup> This section has been adapted from Michael J. Ramos, *Practitioner’s Guide to GAAS 2007* (Hoboken, NJ: John Wiley & Sons, 2007).

An effective way to understand the requirements behind the risk assessment standards is to relate the traditional risk assessment model to the standards. The model is graphically depicted next.



To understand the current risk assessment standard, it is useful to think of SASs 109 and 110 as providing a blueprint for executing audits following the risk assessment guidance while SAS 104 through 108 and 111 generally (but not exclusively) address documentation and definitional issues. The ensuing discussion addresses the standards in that fashion.

### ***Executing the Audit***

SAS 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and SAS 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence*, provide a blueprint for the execution of a risk-oriented audit approach that closely follows the risk assessment model introduced earlier.

To properly carry out the requirements of the model, the auditor must develop an understanding of the entity in order to identify threats and vulnerabilities as well as to

determine materiality and, based on an evaluation of these factors or conditions, evaluate overall risk.

Under the new standards, understanding the entity goes beyond obtaining an organization chart, comparative financial results, and maybe short bios of members of the board of directors. If the auditor is to identify threats and all significant vulnerabilities, he or she must acquire a more in-depth understanding of the auditee's "business." This entails, for example, an understanding of:

- The industry.
- The entity's future plans.
- Organizational goals, regulators, and other stakeholders.
- Entity and industry trends.
- Management, including recent changes and business risks.

Other subjective considerations, such as management's "aggressiveness" and integrity, the internal control environment, and political considerations, are also essential to understanding the entity and determining quantitative and qualitative materiality. Qualitative materiality is of particular concern in a Federal Government environment where a bottom line usually cannot be associated with a net income or a similarly quantifiable concept.

Complementing the in-depth understanding of the entity is the auditor's documentation of significant systems of internal controls. However, the process of developing a preliminary evaluation of internal controls is not based on finding controls that are traditionally included in checklists of good internal controls. At times, auditors tend to concentrate on whether controls traditionally regarded as good (e.g., segregation of duties, two signatures required for large checks, all disbursements are approved, etc.) are present with the corollary being that those are the controls that will be tested.

While good controls are, by definition, always desirable controls, a risk-based approach concentrates on what can go wrong (threats), whether the threat is likely and/or material and whether the controls (even the good ones) that are in place effectively mitigate the risk. Thus, while segregation of duties within an information technology operation is very desirable, it does no good if, for example, the facility is located in a high-flood risk area and not supported by an effective disaster recovery plan. Similarly, a two-signature requirement is of little value if a signature stamp is used and custodial security over the stamp is non-existent. Finally, the approval of all disbursements is of no value if the approver lacks the competence or authority to assert the validity of the disbursement. No matter how positive the statistical testing results are, the tests of "inefficient" controls (e.g., controls with characteristics/deficiencies such as those described above) will be of no value in evaluating the risks of material misstatement of the financial statements.

Understanding the entity (the focus of SAS 109) enables the auditor to identify real risks and mitigating circumstances, which in turn enables the auditor to develop audit procedures that are directly responsive to the evaluation of assessed risk. Thus, the auditor

will audit the reconciliation of a major cash account not just because it is always done (and probably *must* always be done) but because doing so minimizes the risk of a financial statement misstatement occurring as a result of threats and vulnerabilities identified during the planning and internal control evaluation phases of the audit.

### ***Documenting the Audit Process Based on Audit Evidence***

Though not part of the risk assessment standards, SASs 102 and 103 are essential to relating the standards to the risk assessment model. Thus, as noted earlier, these standards set the stage by tightening the definitions of *must* and *should* as well as ensuring that documentation is such that an outsider (i.e., experienced auditor) can follow the risk assessment process and rationale behind the testing approach used.

SASs 104 through 108 and SAS 111 expand on requirements essential to the documentation of a risk assessment–based audit approach. They incorporate the concept of risk assessment in both the general standards and the standards fieldwork and expand on certain definitions as well as addressing in more detail issues such as materiality and audit evidence.

### ***Rest of the 2006 Standards***

SAS 112, *Communicating Internal Control Related Matters Identified in an Audit*, redefined the traditional internal control weaknesses as significant deficiencies and material weaknesses and made mandatory written communications of these to management and those charged with governance. (Prior guidance recommended written communications but did not require them.) SAS 112 was superseded by SAS 115, *Communicating Internal Control Related Matters Identified in an Audit* (issued in October 2008), which added and defined the term *deficiency in internal control* and also formally defined *deficiency in design* and *deficiency in operation*.

SAS 113, *Omnibus 2006*, is, in general, designed to conform all audit guidance to the contents of the risk assessment standards. Among a variety of changes, the standard strengthens the language in the ten professional standards and makes important changes to the dating of the management representation letter (which now must coincide with the date of the auditor's report).

SAS 114, *The Auditor's Communications with Those Charged with Governance*, increases the auditor's scope pertaining to communications with the entity's stakeholders and formally defines the phrase *those charged with governance* to encompass a larger audience than the previously used *audit committee*.



In conclusion, the standards require a risk-oriented approach to auditing as essential to the execution of professional audit engagements. However, these standards also recognize that

the proposed approach can be highly subjective. Identifying potential threats, vulnerabilities, and overall risk requires a rigorous thought process. It is essential that the auditor document the rationale behind his or her approach, including the selection of controls tested and accounts subject to substantive procedures.

The standards already discussed provide the guidance to develop and execute effective testing procedures based on the risk evaluation process and to document the process in sufficient detail to satisfy the experienced auditor requirement, obtain audit evidence, provide for proper supervision, effectively consider materiality at the financial statement and assertion levels, and promote improved communications with the auditee.

A listing of standards issued since 2006 appears next.

### ***Recent Standard***

<i>SAS No.</i>	<i>Title</i>
115	Communicating Internal Control Related Matters Identified in an Audit
116	Interim Financial Information
117	Compliance Audits
118	Other Information in Documents Containing Audited Financial Statements
119	Supplementary Information in Relation to the Financial Statements as a Whole
120	Required Supplementary Information
121	Revised Applicability of Statement on Auditing Standards No. 100, Interim Financial Information
122	Statements on Auditing Standards: Clarification and Recodification
123	Omnibus Statement on Auditing Standards—2011
124	Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country
125	Alert That Restricts the Use of the Auditor's Written Communication
126	The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern (Redrafted)

SASs 122 through 126 are part of the AICPA project to redraft previous SASs to clarify auditing standards and thus facilitate auditor compliance with the guidance. With the issuance of SAS 126 in October 2012, this project is virtually completed, although more related SASs are likely to be issued. This is a recent effort, and it is too early to tell whether the “clarification” goal has been achieved. The litmus test will come over the next few years as auditors adapt to the new clarified guidance.

A more detailed discussion of the standards just listed is beyond the scope of this chapter; relevant requirements of these standards are incorporated in the audit execution approach discussed in later chapters.

AICPA's Clarity Project, SASs 122 through 126, are part of the AICPA's project to redraft previous SASs to clarify auditing standards and thus facilitate auditor compliance with the guidance. With the issuance of SAS 126 in October 2012, this project is virtually complete, although more related SASs are likely to be issued. This is a recent effort, and it is too early to tell whether the “clarification” goal has been achieved; the litmus test will come over the next few years as auditors adapt to the newly clarified guidance.



Notwithstanding the lack of actual experience with these revisions, there is one section of the Clarity Project that will likely have an immediate impact on Federal auditing: AU-C 600, *Using the Work of Others—Special Considerations—Audits of Group*.<sup>2</sup>

The section “Financial Statements (Including the Work of Component Auditors)” significantly expands the prior guidance set forth in AU 543 *Part of Audit Performed by Other Independent Auditors*. AUC-600.11 introduces a number of definitions around which the guidance is developed. Key among these definitions are (1) *component*, defined as an entity or activity which contains financial information that must be included in the financial statements of the group; and (2) *group*, which is defined as the aggregate of the components with financial information that is required to be included in the group’s financial statements.

Following the risk-based audit approach discussed earlier, AU-C 600 provides guidance covering the duties, requirements, and responsibilities of both the component and the group auditors. In addition, the guidance discusses alternatives available to the group auditor in defining the level of responsibility he/she assumes in connection with the group financial statements (e.g., whether the group auditor refers to the component auditor’s work in the group audit opinion, which in turn impacts the scope of the group auditor’s work in connection with the component financial results and verification of the component auditor’s credentials and work papers).

Virtually all departmental-level Federal audits and a number of other large Federal audits include component auditors (often multiple component auditors), as agencies strive to cope with the large sizes of entities and also comply with small business and minority participation requirements covering Government contracting. In addition, the Federal Accounting Standards Advisory Board (FASAB) has issued a proposed amendment to the definition of the reporting entity, dated April 3, 2013, with comments requested by July 3, 2013. This amendment expands on the definition of the entity and is likely to include the number of component financial statements to be encompassed by Federal group audits. Based on this information, we believe the revised guidance will have an immediate and significant impact on Federal audits.

Although it is too early to tell whether the Clarity Project will achieve its goal, the expanded guidance in AU-C 600 is virtually guaranteed to provide for a smoother working relationship between component and group auditors by defining each party’s duties and responsibilities in more detail.

A more detailed discussion of the Clarity Project is beyond the scope of this chapter; however, we strongly recommend that auditors of Federal entities develop their own internal

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<sup>2</sup> AU citations refer to sections of the American Institute of Certified Public Accountants’ (AICPA) annual publication of its professional standards, the U.S. Auditing Standards. The AICPA is currently engaged in a clarification and recodification effort that will replace the current AUs. The term *AU-C* refers to section numbers that have replaced AU numbers. Once this effort is completed (anticipated 2014), all references will revert back to AU.

audit checklists on AU-C 600 to ensure compliance with the new standard. In this regard, and in anticipation of an expanded definition of the components of a Federal entity, we believe the profession would welcome the issuance of a GAO checklist addressing this issue.

## RECENT DEVELOPMENTS IN FEDERAL GUIDANCE

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Arguably, the 2006 standards discussed previously did not significantly change Federal audit guidance. A risk-oriented approach to auditing has always been the standard in the execution of audits conducted pursuant to the Chief Financial Officers Act (CFO Act) and Government Management Reform Act requirements. The more rigorous definition of terms, such as *must* and *should* (see earlier discussion), was part of the Federal standard well before the issuance of SAS 102, as was the requirement for more stringent documentation standards and the “experienced auditor” as reviewer standard.

### GAO’s Yellow Book Standards

Perhaps the most compelling argument in this regard is the effect of the new standards on GAO’s Yellow Book standards. In general, GAO’s *Government Auditing Standards* adopt the AICPA standards and add standards of its own based on GAO’s opinion regarding the needs of the Federal Government (or possibly, although never stated as such, to compensate for any standards that GAO finds wanting). For all practical purposes, the codification of these standards contained in GAO’s Yellow Book is a listing of additional guidance/requirements. A comparison of the 2003 and 2011 Yellow Books shows a very telling reduction in the number of additions GAO felt were needed to support government (Yellow Book) audits:<sup>3</sup>

- The fieldwork and reporting standards are now covered by one chapter (Chapter 4), down from two chapters (Chapters 4 and 5) in 2003.
- The 2011 revision dedicates 20 pages to the fieldwork and reporting standards, down from 32 pages in the 2003 revision.
- The 2003 revision contained 64 paragraphs each essentially adding requirements to government audits in connection with fieldwork and reporting standards. The 2011 version reduced the number of paragraphs/requirements to 48.
- By way of an example showing the impact of the AICPA’s adoption of standards similar to GAO’s, the Yellow Book audit documentation section no longer mentions the “experienced auditor” concept (since it is specifically addressed by SAS 102) and consists of two paragraphs and approximately one page of text; the 2003

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<sup>3</sup> This comparison is taken from GAO’s *Government Auditing Standards, 2003 Revision*, and *Government Auditing Standards, 2011 Revision*. (Note: A 2007 revision was also published, but due to the timing of the 2006 AICPA standards, the results were not as streamlined as the ones that were published in the 2011 revision.)

version adds the “experienced auditor” concept as unique to government auditing standards and consists of five paragraphs and three pages of text.

- A second example shows a significant decrease in requirements (see Chapter 4) reporting weaknesses in internal controls as a result of the issuance of SASs 114 and 115.

These examples suggest that the revised AICPA standards appear to have a lesser impact on government audits and that AICPA standards are moving closer to government auditing standards. However, the discussion should not be interpreted as implying that the changes have had no impact whatsoever on government auditing.

The discussions that follow summarize changes and revisions issued by GAO and OMB in recent years.

### **GAO’s *Financial Audit Manual***

In 2008, GAO issued revisions to its *FAM* to account for changes and new guidance. According to the *FAM*’s introduction these changes included new guidance from these organizations:

- AICPA’s Auditing Standards Board
- GAO
- OMB
- FASAB
- Laws and regulations

More specifically, the *FAM* identified among others:

- SASs 100 through 114
- The 2007 revision of *Government Auditing Standards*
- OMB Bulletin 07-04, *Audit Requirements for Federal Financial Statements*
- Revised OMB Circular A-136, *Financial Reporting Requirements*

Exhibit 6.1 reproduces the Table of Major Changes to *FAM* included in the 2008 revision. Note that the first major change addresses the audit risk standards and emphasizes the fact that the *FAM* has always followed a risk-based methodology in support of government audits. While it is important for Federal auditors to follow the guidance included in the *FAM*, it should also be noted that many (if not most) changes are definitional in nature and that it is at least arguable that no significant modification to the audit methodology prescribed by Yellow Book standards and the *FAM* has taken place.

### **OMB’s Audit Requirements for Federal Financial Statements (Bulletins 06-03 and 07-04)**

OMB’s responsibility for developing guidance in connection with accounting, auditing, and financial management is discharged through the issuance of bulletins and circulars. Currently, OMB guidance for Federal financial audits is contained in OMB Bulletin 07-04

<b>EXHIBIT 6.1 Major Changes to the FAM</b>	
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<i>FAM Section</i>	<i>Major Change</i>
100–500	The audit risk standards (SAS Nos. 104-111), effective for audits of financial statements for periods beginning on or after December 15, 2006, provide guidance concerning the auditor’s assessment of the risk of material misstatement (whether caused by error or fraud) in a financial statement audit and the design and performance of audit procedures whose nature, extent, and timing respond to assessed risks. These standards also provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion on the financial statements. While the <i>FAM</i> has always used a risk-based methodology, many changes were made throughout <i>FAM</i> Volume 1 to comply with the terminology and guidance of the risk standards, particularly in <i>FAM</i> 200 on audit planning.
110.28	“Must” as used in the <i>FAM</i> now indicates a required procedure (mostly by professional standards) where the auditor’s failure to perform means the auditor will not be able to express an unqualified opinion on the entity’s financial statements. Minor clarifications have been made to the definitions of the related terms “should,” “generally should,” and “may.”
215, 215 A, 215 B	These are new sections of the <i>FAM</i> that address establishing an understanding with the client. They include guidance for identifying the client and those charged with governance in the Federal environment; issues of audit scope; matters to be communicated to management and those charged with governance (following SAS Nos. 112 and 114, and GAGAS); and the use of engagement, intent, notification, and commitment letters. <i>FAM</i> 215 A provides two example of an engagement letter (SAS No. 108), and <i>FAM</i> 215 B provides an example of a letter to those charged with governance. Some of this information was previously in <i>FAM</i> 280.06-.09.
230.05	The term “test materiality” was changed to “tolerable misstatement,” consistent with SAS No. 107.
235	The definitions of the assertions were revised to be consistent with SAS No. 106. This standard identifies 13 financial statement assertions, which are grouped in the <i>FAM</i> into 5 assertions, as shown in <i>FAM</i> 235.08. The revised assertion definitions do not significantly affect the related potential misstatement definitions in the <i>FAM</i> used for audit planning and testing.
260	The term “combined risk” was changed to “risk of materials misstatement” and is the auditor’s combined assessment of inherent risk and control risk (SAS No. 107). <i>FAM</i> 260.13–.17 now discuss identification and communication of the risk of material misstatement among the audit team, including “brainstorming” sessions (SAS No. 109). <i>FAM</i> 260.67–.70 have been added to discuss work conducted under the Federal Information Security Management Act of 2002 and its relationship to the auditor’s risk assessment.
285	When planning locations to visit, the auditor now should rely only on controls tested for the current year and past two years, after determining that there were no changes (SAS No. 110), rather than the previous five years.
290	Documentation requirements were expanded to include the understanding established with the client ( <i>FAM</i> 215); audit strategy (SAS No. 108.13–.14) as part of the General Risk Analysis; effect of the risk of material misstatement, including fraud risk on the audit strategy; changes to the assessment of risk of material misstatement, including fraud risk during the audit (SAS No. 109); audit plan/procedures expected to reduce audit risk to an acceptably low level (SAS No. 108); and communication of audit issues ( <i>FAM</i> 290.11) to include those charged with governance (SAS No. 112 and 114).

(continued)

**EXHIBIT 6.1 Continued**

<i>FAM Section</i>	<i>Major Change</i>
295 B	FAM 295 B.12 expands identifying and analyzing risks of material misstatements (SAS No. 109) within the entity's risk assessment process. FAM 295 B.17 includes consideration of OMB Circular No. A-123 reviews.
310	The overview was expanded in FAM 310.01 on how the auditor should use results of internal control work and a new FAM 310.02 explains that auditors may no longer default to maximum for the control risk assessment when designing further audit procedures (SAS No. 110). New FAM 310.11-.13 discusses use of SAS No. 70 reports in the financial audit.
320	FAM 320.03 expanded the discussion of the auditor's understanding of the accounting system(s).
350	A new FAM 350.21 expanded the discussion regarding the timing of control tests that was formerly in FAM 350.17.
380	FAM 380.01 expanded the discussion of multiyear testing of controls (SAS No. 110).
390	A new FAM 390.03 was created to document audit procedures and conclusions on multiyear testing.
410	The overview was reorganized to better present the audit work to be done during the testing phase.
420	New FAM 420.01-.02 were created to explain designing further audit procedures.
450	A new FAM 450.01 was added on performing tests of controls.
470	FAM 470.01-.03 were revised to discuss substantive procedures and detection risk.
475	FAM 475.04 was added for designing substantive analytical procedures as discussed in SAS No. 110.
490	FAM 490.01-.04 were revised for documenting assessed risk of material misstatement at the relevant assertion level (SAS No. 110) and for classifying deficiencies as material weaknesses, other significant deficiencies, or other control deficiencies (SAS No. 112).
540	FAM 540.07-.08 were revised for discussing misstatements with management and those charged with governance (SAS No. 114).
550	FAM 550.13-.16 were added to discuss communication with those charged with governance (SAS No. 114).
580	FAM 580.01 was revised to indicate that non-GAO auditors may report FFMIA with compliance with laws and regulations. FAM 580.33-.34 were revised and FAM 580.35 was added on control deficiency, significant deficiency, and material weakness (SAS No. 112). FAM 580.82 on other information in the annual financial statement was expanded through FAM 580.84. A new FAM 580.85 was added on dating the auditor's report (SAS No. 103); new FAM 580.86-.87 were added on other reporting matters concerning restatements and information contained in the Performance and Accountability Report.
590	FAM 590.08-.10 have been added for documenting subsequent discovery of facts, condensed financial statements, and exit conference.
595 A	A new example 2 report was added for reporting internal control deficiencies without expressing an opinion on control effectiveness. Both example reports reflect new terminology consistent with changes in professional standards. Both examples indicate that non-GAO auditors may report FFMIA with compliance with laws and regulations.
595 B	Example modifications to the auditor's report were revised for terminology in new standards.
595 C	New narrative in FAM 595 C.01-.15 was added for discussing uncorrected misstatements and adjusting entries with management (SAS No. 107) and those charged with governance (SAS No. 114). Also, new examples are provided of the Schedule of Uncorrected Misstatements and the Summary of Uncorrected Misstatements.
595 D	Example Summary of Unadjusted Misstatements has been eliminated, and examples are now provided in FAM 595 C.

and guidance for Federal financial reporting requirements is contained in Circular A-136 (2010 revision).

OMB is also responsible for issuing guidance on internal controls applicable to Federal Agencies. Control guidance can be found in a number of OMB publications, most notably Circular A-123 (2004 revision) and the accompanying Appendix A, covering an Implementation Guide and Implementation Plans (both issued in 2005).

Although Circular A-123 does not address auditing directly, it is probably the most significant financial management–related document issued by OMB in this millennium. Circular A-123 makes it clear that internal controls are the responsibility of all members of management, not just financial managers, and adopts the *COSO Framework* as the standard for Federal internal controls.

In addition, Circular A-123 guidance provides a methodology for management to annually evaluate and report management’s assessment of their entity’s internal controls. Circular A-123 preceded the issuance of SAS 109; however, its emphasis on management’s responsibility for internal controls, including the need for management to have a risk assessment methodology for evaluating internal controls, conforms very closely to SAS 109’s definition of desired management involvement in internal controls.

The issuance of Circular A-123 guidance as well as the new SASs was followed by revisions to OMB’s Audit Requirements reflected in the issuances of Bulletin 06-03 and 07-04. Notable changes designed to conform to AICPA guidance included:

- Changes to the definitions of *material weakness*, *reportable condition*, and *significant deficiency* to conform to SAS 112 definitions as well as OMB Circular A-123 definitions (Bulletin 06-03).
- In response to SAS 114, Bulletin 06-03 emphasizes the need for communications between auditors and management, including a requirement that legislators and appropriate regulatory/oversight bodies be informed when an audit uncovers material misstatements in previously issued financials. These requirements were expanded and further clarified in Bulletin 07-04.
- Revised OMB guidance to more closely conform to U.S. Auditing Standards—AICPA (AU) 324, *Service Organizations*; AU 552, *Reporting on Condensed Financial Statements and Selected Financial Data*; and SAS 103, *Audit Documentation* (Bulletin 07-04).

# 7 THE FEDERAL AUDIT MODEL

The Federal audit model has many similarities to its commercial counterpart; however, it has just as many significant differences. It is imperative that an auditor be properly trained in the Federal accounting and reporting environment in order to effectively execute a Federal audit. The size of Federal entities is equivalent to the largest of international corporations. No auditor without sufficient training would ever attempt to audit any of these corporate entities.

<i>Federal Entity</i>	<i>Budget* (\$ billions)</i>	<i>International Corporation</i>	<i>Revenue (\$ billions; as of April 2012)</i>
Department of Defense	\$530	ExxonMobil	\$433
Department of Health and Human Services	\$78	Microsoft	\$72
Department of Education	\$67	Toyota	\$69
Department of Veterans Affairs	\$58	Boeing	\$68
Department of State and other international programs	\$44	AIG	\$64

\*FY 2013 Budget of the U.S. Government

Second, the hierarchy of generally accepted accounting principles (GAAP) is unique for Federal entities. The Federal Accounting Standards Advisory Board (FASAB) was designated as the accounting standards-setting body for Federal entities under Rule 203 of the Code of Professional Conduct of the American Institute of Certified Public Accountants (AICPA) in 1999. FASAB defined the hierarchy of GAAP in the Statement of Federal Financial Accounting Standards (SFFAS) 34, *The Hierarchy of Generally Accepted Accounting Principles for Federal Entities, Including the Application of Standards Issued by the Financial Accounting Standards Board*, in 2009. An auditor must be familiar with this hierarchy and all FASAB pronouncements in addition to laws, regulations, and Office of Management and Budget (OMB) and Government Accountability Office (GAO) guidance in order to audit in the Federal environment. Last, the unique and diverse missions of the Federal Government, its unique assets, and its budgetary accounting and reporting requirements all add additional layers of complexity to the Federal audit process. Auditors must become familiar with the unique characteristics of the specific entity they are auditing before they begin the audit process.

## AUDIT CHECKLISTS AND MODELS

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Over the years, virtually every accounting firm and Federal Agency involved in the execution of financial statement audits has developed an audit model along with supporting audit checklists and audit programs to guide the efforts of their staff. GAO, with the President's Council on Integrity and Efficiency (PCIE), has compiled two manuals directly relevant to the conduct of Federal audits: the *Financial Audit Manual (FAM)* and the *Federal Information System Controls Audit Manual (FISCAM)*. These documents, superbly researched and the labor of many months, are comprehensive (the three-part *FAM* is nearly 1,250 pages and *FISCAM* is another 600 pages) guides based on generally accepted auditing standards (GAAS) covering virtually every possible aspect of a Federal financial audit. The availability of such guidance may make auditors wonder why any planning must be done when such working models and well-defined audit procedures are readily available.

Every audit is unique. Applied audit procedures must be tailored to the conditions and circumstances encountered, which differ not only from agency to agency but within a single agency from one year to the next. Models are very useful in planning, but it does not follow that every audit consists of the execution of predetermined steps or procedures.

Audit manuals are not a substitute for audit judgment. Circumstances and conditions specific to a particular agency may make the application of the *FAM* guidance entirely appropriate. However, the *FAM*'s audit model notes that judgment must be exercised in applying the model. It is expected that the tasks and activities suggested will require modification, refinement, and/or supplementation.

## FEDERAL AUDIT MODEL

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The Federal audit model outlined in the *FAM* provides a framework for performing financial statement audits in accordance with the *Government Auditing Standards* (Yellow Book), integrating the requirements of the Federal accounting standards and assessing compliance with laws and regulations and internal controls. The Yellow Book incorporates, by reference, all of the generally accepted field auditing standards, audit reporting standards, and attestation standards established by the AICPA.

The methodology outlined in the government's *FAM* audit model was also designed to meet compliance requirements prescribed by several other Federal-wide criteria and guidance, such as those prescribed by these organizations or acts:

- Federal Managers' Financial Integrity Act (FMFIA) of 1982
- Chief Financial Officers Act (CFO Act)
- PCIE
- Federal Financial Management Improvement Act (FFMIA) 1996
- FASAB
- OMB



## PHASES OF FEDERAL AUDITS

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At the outset of any audit, the auditor must have a clear idea of the objectives of the audit in order to identify an audit scope, audit process, and audit procedures that will achieve those objectives. Naturally, it helps to have a model.

For financial audits, several useful models exist. One such model, applied in the execution of financial audits of Federal Agencies, is the model jointly developed by GAO and the PCIE. Their audit model, as detailed in the *FAM* and *FISCAM*, describes an audit of a Federal Agency's financial statements that is comprised of four phases:

Phase I. Planning the audit and assessing financial processes and systems

Phase II. Understanding and evaluating the internal controls

Phase III. Testing controls and substantive audits of transactions, accounts, and account groups

Phase IV. Reporting audit conclusions, audit results, auditor's opinion, and other assurances

### **Phase I: Planning the Audit**

The purpose of Phase I is to develop a preliminary understanding of the operations of the auditee, the auditee's internal controls and financial systems, including an initial review of the auditee's computer-based support systems. The auditor's initial understanding of these systems is augmented during each subsequent phase of the audit, as control systems are further evaluated and tested. It is important to realize that planning a financial audit is not a one-time-only task but rather an interactive process.

An objective of this initial phase of planning is to identify significant areas of risks and issues required by law and regulations to be examined and to design appropriate evaluative audit procedures. To accomplish this, the auditor must conduct a review early on to rapidly acquire an understanding the Federal Agency's operations, organization, management style and systems, applied internal controls, and external factors that influence its operations. In this phase, it is imperative that the auditor also identify all significant accounts, accounting applications, key financial management systems, material appropriation restrictions, budget limitations, and provisions of applicable laws and regulations.

The planning phase is where the auditor must assess and acquire an understanding of the relative effectiveness of both an agency's systems of internal financial controls and its information systems (IS) controls, with the objective of identifying high-risk areas, potential risks of fraud, and possible abuses of financial resources.

### **Phase II: Understand and Evaluate Internal Controls**

The purpose of Phase II is to assess and obtain a comprehensive working knowledge of the current state and design of the internal control systems and work flows of a

Federal Agency's significant systems. This includes such systems as budget, financial reporting, procurement, revenue/cash receipts, cash disbursements, payroll, and data processing. At this phase's conclusion, the auditor should have evaluated the system's design and related internal financial controls and identified the system's design strengths and weaknesses and potential audit obstacles that will require refinement of the planned audit approach.

This phase requires internal controls to be assessed to support the auditor's initial evaluations about the:

- *Reliability of financial reporting.* Whether transactions are properly recorded, processed, and summarized to permit the preparation of the principal statements and required supplementary stewardship information (RSSI) in accordance with GAAP and whether assets are safeguarded against loss from unauthorized acquisition, use, or disposition
- *Compliance with applicable laws and regulations.* Whether transactions are executed in accordance with: (1) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the agency principal statements or RSSI and (2) any other laws, regulations, and government-wide policies identified by OMB in its audit guidance.

The AICPA's attestation standards, incorporated by reference into the government's auditing standards, permit an auditor to give an opinion on internal control or on management's assertion about the effectiveness of internal control. There is an exception if material weaknesses are present; then the opinion must be limited to internal controls and not management's assertion. Additionally, OMB's audit guidance includes a third objective of internal control related to performance measures.

Thus, an evaluation of internal controls requires the auditor to identify and understand the relevant controls and assess the relative effectiveness of the controls, which will then be tested later in the audit. Where controls are considered effective, reliance may be placed on such controls, and the extent of later substantive testing (e.g., detailed tests of transactions and account groups) can be reduced. The *FAM* model methodology includes relevant guidance to:

- Assess specific levels of control risk.
- Select the financial controls to be tested.
- Determine the effectiveness of IS controls.
- Test the controls, including the coordination of the more extensive (sampling) control tests to be conducted in the later testing phase.

During the internal control phase, the auditor should understand the entity's significant financial management systems and test systems compliance with FFMLA requirements.

### **Phase III: Test Controls, Transactions, Account, and Account Groups**

Phase III encompasses tests of controls and the performance of substantive testing (e.g., tests of the transactions and accounts and the conduct of analytic review procedures). Upon conclusion of internal control testing, the auditor will have either verified the initial control evaluation or identified conditions that require a revision of the initial evaluation.

Internal control testing will be followed by substantive testing. The extent of substantive testing will depend on the auditor's (revised, if applicable) final evaluation of internal controls. Evidence acquired from performing substantive audit procedures, when considered in conjunction with the results of internal control testing, is a critical determinant as to whether an agency's financial statements are free of material misstatements. Some important audit objectives of the testing phase are to:

- Obtain reasonable assurance about whether the financial statements are free from material misstatements.
- Determine whether the entity complied with significant provisions of applicable laws and regulations.
- Assess the effectiveness of internal control through actual testing of the controls applied and practiced by agency employees.

To do this, the *FAM* model audit methodology includes guidance on the:

- Design and performance of substantive, compliance, and control tests.
- Design and evaluation of evidence obtained in audit samples.
- Correlation of risk and materiality with decisions on the nature, timing, and extent of substantive audit tests.
- Design of dual-purpose tests, using a common sample to test several different controls, transactions, and specific accounts.
- Execute tests, and, based on test results, validate or revise the initial evaluation developed during Phase II.

### **Phase IV: Reporting Audit Conclusions, Audit Results, and the Auditor's Opinion**

During Phase IV, the auditor considers the evidential result of testing tasks and other audit activities, completes a number of end-of-audit procedures, makes a final technical review of the audit procedures performed, and concludes whether sufficient evidential matter has been obtained to support the audit opinion and other assurances the auditor

must provide on an agency's financial statements and other information included in the auditor's report.

Key audit tasks and procedures of this phase involve preparation of the auditor's report on an agency's:

- Financial statements (i.e., the principal statements).
- Other information, such as management discussion and analysis (MD&A).
- Other required supplementary information and accompanying information required by the GAAP and issued by FASAB.
- Results of audit tests made of internal controls.
- Financial management systems employed by the agency to substantially comply with FFMIA requirements.
- The results of audit tests for compliance with laws and regulations.

Exhibit 7.1 is an overview of the numerous audit tasks, activities, and audit procedures suggested by GAO and the PCIE in the *FAM* that should<sup>1</sup> be performed for most Federal financial statement audits. Several of the following chapters contain additional discussions of some audit tasks and activities most often applied in practice. It is important to recognize that, in practice, an audit is a continuum of tasks and activities that must be completed within a finite budget and in a coordinated manner to permit the timely communication of the audit results to the government.

The *FAM* and the execution of Federal audits are influenced by standards, concepts, guidelines, manuals, procedures, and techniques as well as specific circumstances encountered during the performance of the audit itself. These factors and their effect(s) on the audits of Federal entities are detailed in the following sections.

## **GOVERNMENT AUDITING STANDARDS: NOT STAND-ALONE STANDARDS**

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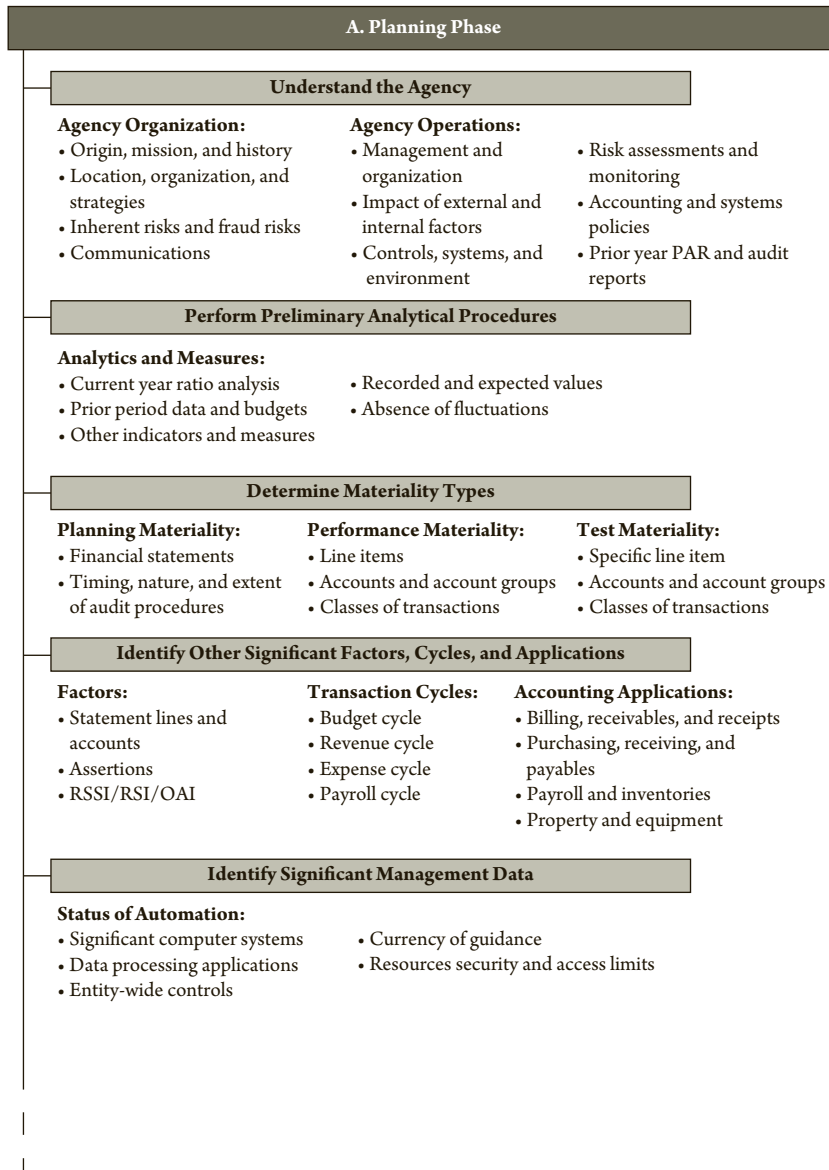
The *Government Auditing Standards* are not a stand-alone set of auditing standards. For prescribed audits, both GAGAS and GAAS of the AICPA must be applied for an audit to comply fully with the GAGAS criteria. Each revision of GAGAS contains references to the fact that GAGAS incorporates all of the AICPA's GAAS and all the AICPA's Statements on Auditing Standards, unless specifically exempted by GAO. Since the initial edition of GAGAS in 1972, GAO has not exempted an AICPA auditing standard. The beginnings of the Yellow Book can be traced to meetings as early as 1968 between state auditors and the Comptroller General at which the case was made to GAO that state and Federal auditing

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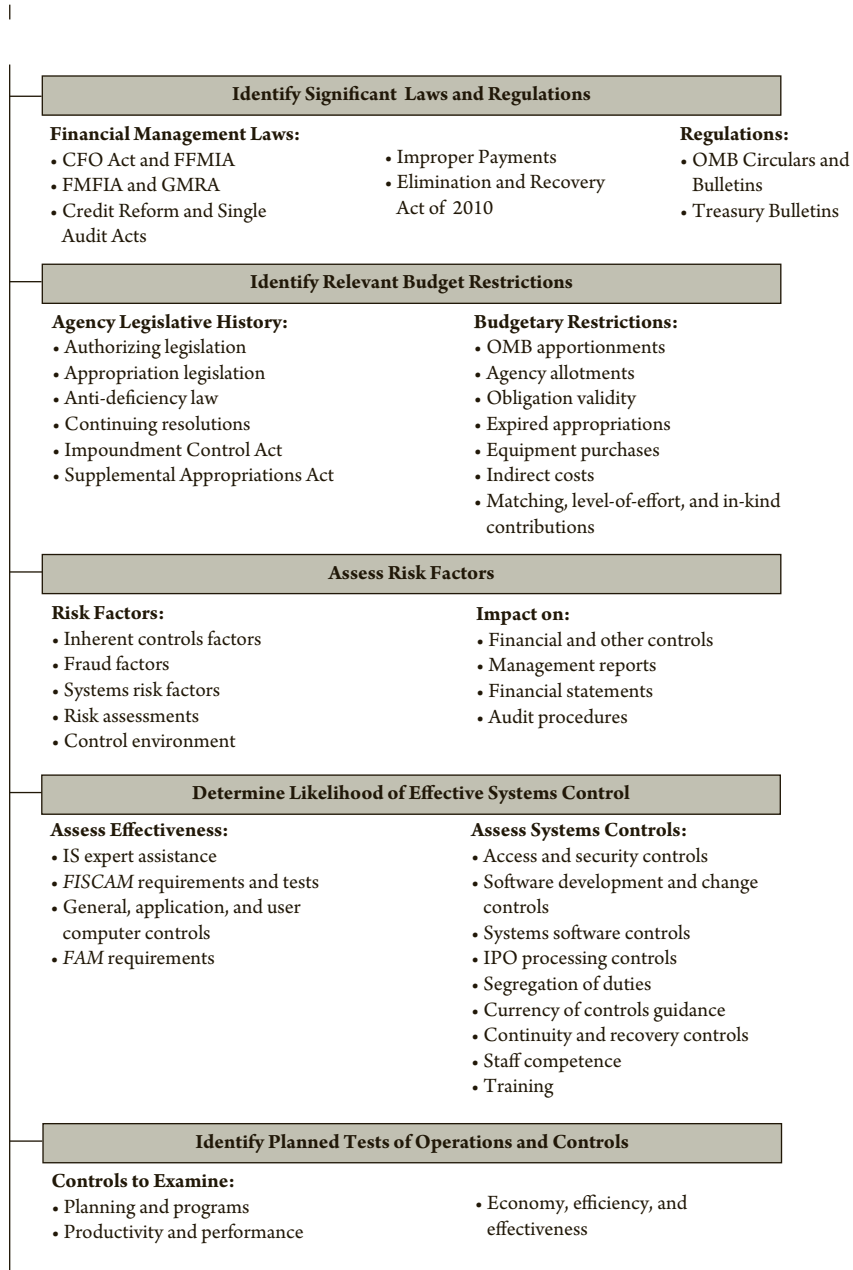
<sup>1</sup> The Federal Financial Management Improvement Act of 1996 Congress required that "each agency shall implement and maintain financial management systems that comply substantially with 1) Federal financial management systems requirements, 2) applicable Federal accounting standards, and 3) the United States Government Standard General Ledger at the transaction level."

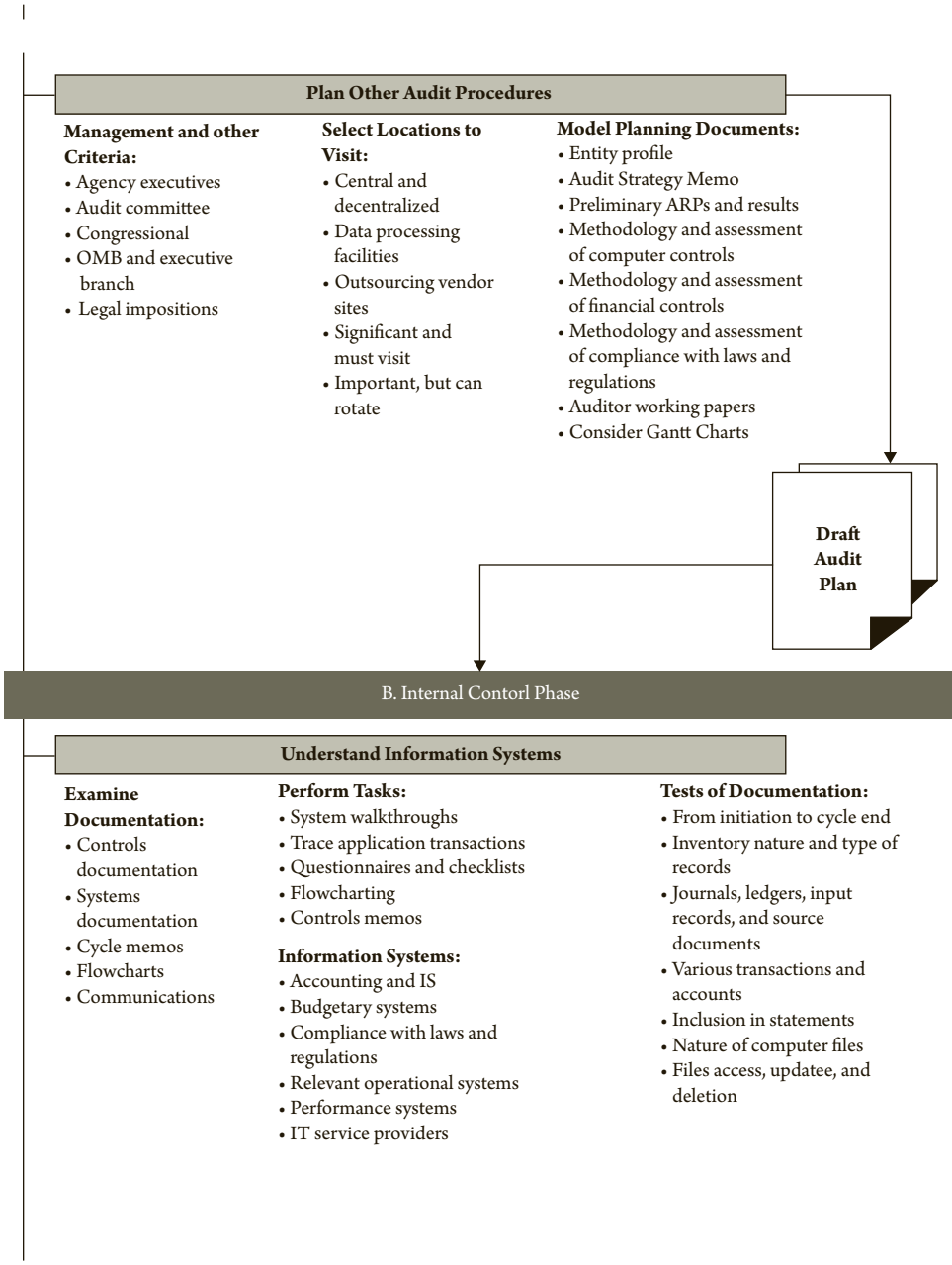
practices left much to be desired and that a unique body of auditing standards was needed to rectify this deficiency.

GAO’s audit and investigatory authority permitted audits and examinations to be made of Federal and non-Federal entities as well as Federal contractors, grantees, not-for-profits, educational institutions, and others receiving Federal financial assistance. Subsequent



**EXHIBIT 7.1 Federal Audit Model—Agency Financial Statements**





**Plan Other Audit Procedures**

**Management and other Criteria:**

- Agency executives
- Audit committee
- Congressional
- OMB and executive branch
- Legal impositions

**Select Locations to Visit:**

- Central and decentralized
- Data processing facilities
- Outsourcing vendor sites
- Significant and must visit
- Important, but can rotate

**Model Planning Documents:**

- Entity profile
- Audit Strategy Memo
- Preliminary ARPs and results
- Methodology and assessment of computer controls
- Methodology and assessment of financial controls
- Methodology and assessment of compliance with laws and regulations
- Auditor working papers
- Consider Gantt Charts

**Draft Audit Plan**

**B. Internal Control Phase**

**Understand Information Systems**

**Examine**

**Documentation:**

- Controls documentation
- Systems documentation
- Cycle memos
- Flowcharts
- Communications

**Perform Tasks:**

- System walkthroughs
- Trace application transactions
- Questionnaires and checklists
- Flowcharting
- Controls memos

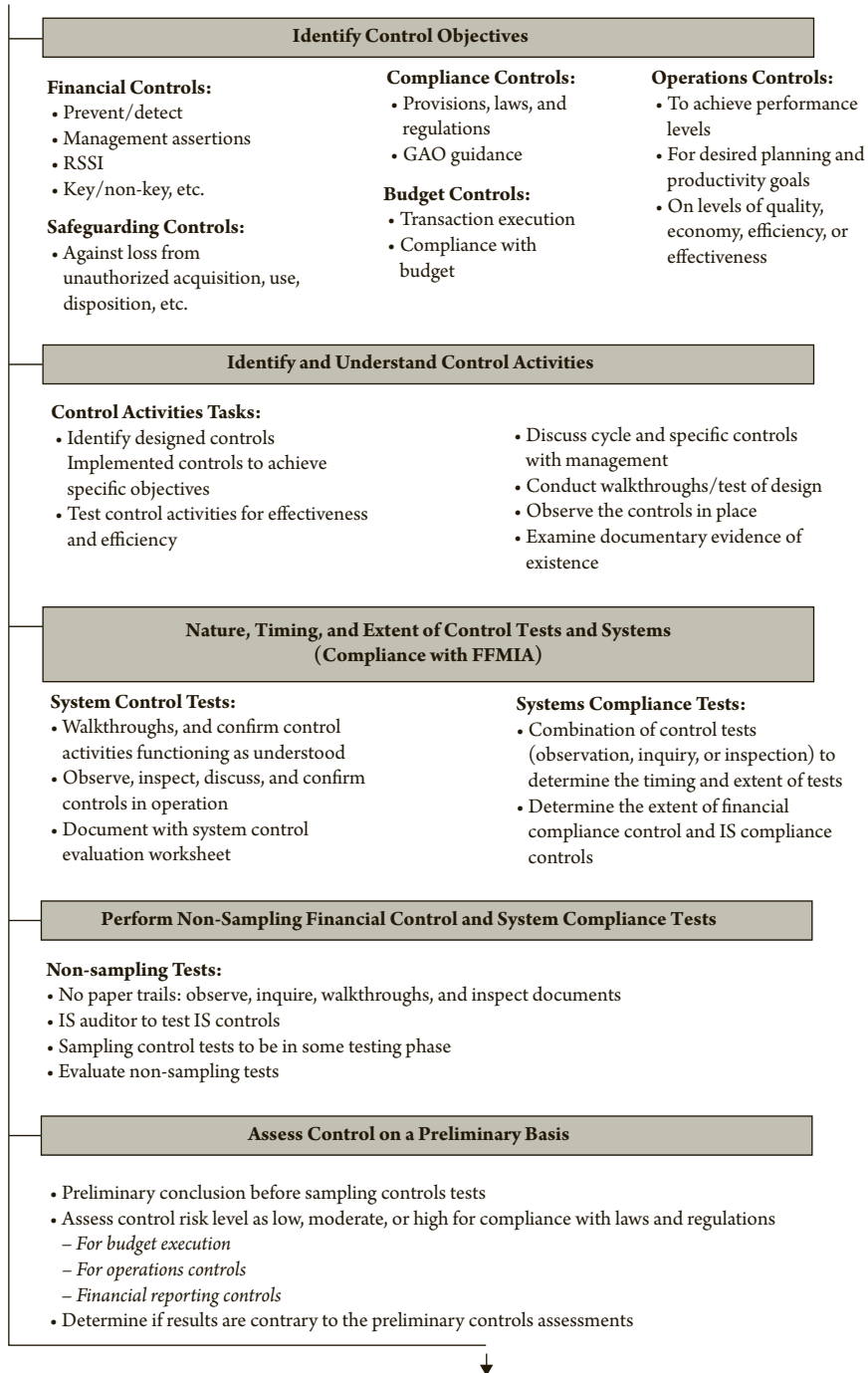
**Information Systems:**

- Accounting and IS
- Budgetary systems
- Compliance with laws and regulations
- Relevant operational systems
- Performance systems
- IT service providers

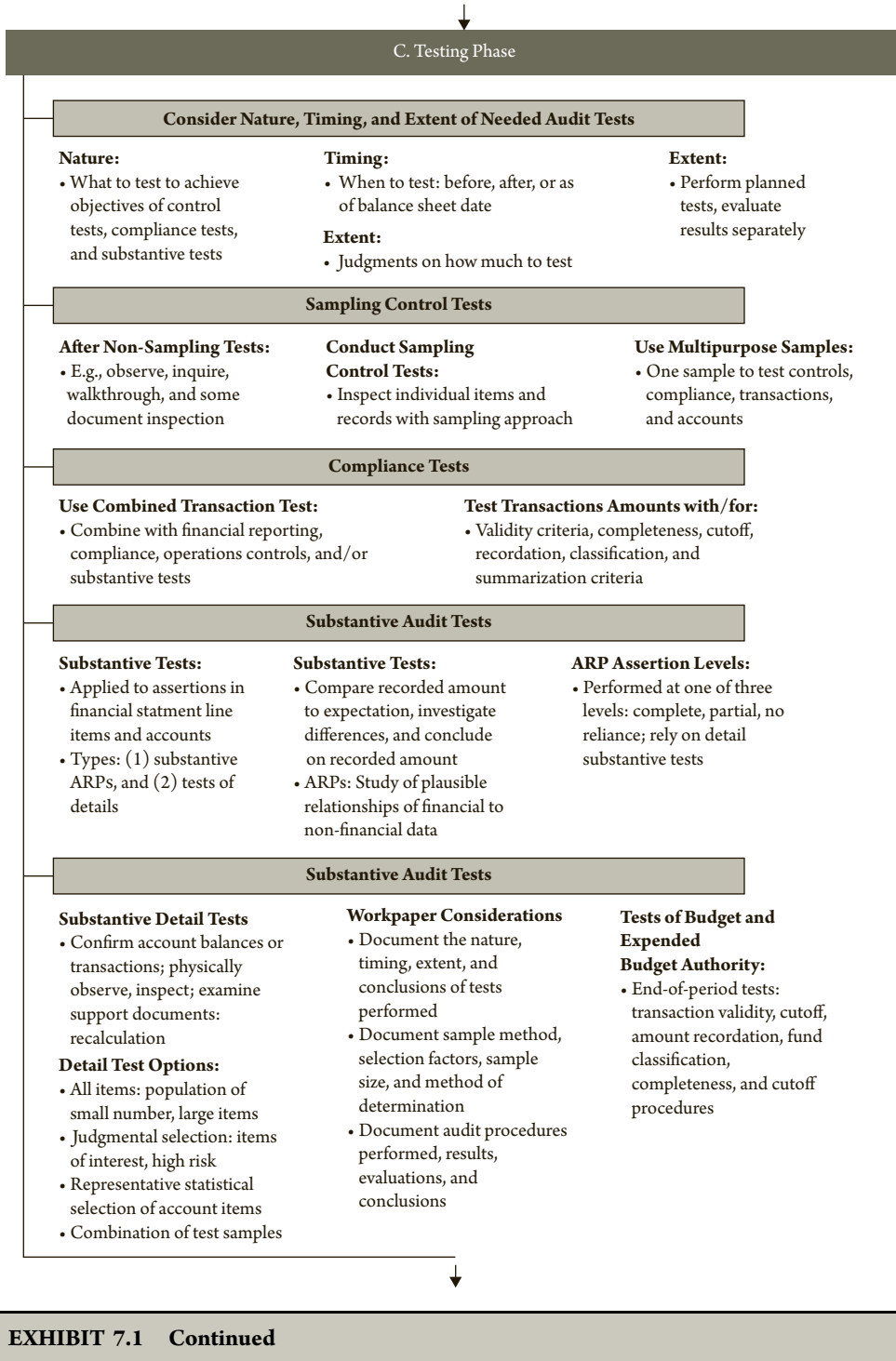
**Tests of Documentation:**

- From initiation to cycle end
- Inventory nature and type of records
- Journals, ledgers, input records, and source documents
- Various transactions and accounts
- Inclusion in statements
- Nature of computer files
- Files access, update, and deletion

**EXHIBIT 7.1 Continued**









**D. Reporting Phase**

**Perform Overall Analytical Procedures**

**Overall ARPs—Required by GAAS to:**

- Determine understanding of fluctuations, relationships in the financial statements have been obtained by other audit procedures
- Determine if audit evidence is consistent with explanations for fluctuations in overall ARPs
- Assist in forming an opinion on financial statements that is consistent with the conclusions reached during tests of individual account balances and classes of transactions

**Determine Adequacy of Audit Procedures and Audit Scope**

**Sufficiency of Tests:**

- Assess if substantive audit procedures were sufficient (i.e., appropriate, adequate samples for detail tests, and to investigate differences versus substantive ARPs)

**Agency’s Position on Audit Opinion:**

- Bring misstatements to management’s attention
- Encourage entity management to correct misstatements
- Determine cause of misstatements and make adjustments

**Options to**

**Challenged Findings:**

- Management to perform procedures, as reviewing all or substantially all of the items to refine estimated misstatements
- Auditor increase assurance of misstatement by testing additional items

**Evaluate Misstatements/Types of Misstatements**

**Evaluate Misstatements:**

- Quantify the misstatements and classify as:
  - Known—missated amounts found by auditor
  - Likely—auditor’s best estimate of missated tested population

**Accumulate Adjustments:**

- Correct all known and likely misstatements
- Summarize all detected and those the entity corrected
- Consider all misstatements for impact on the audit
- Consider misstatements in evaluating the risk of further misstatement for unadjusted misstatements

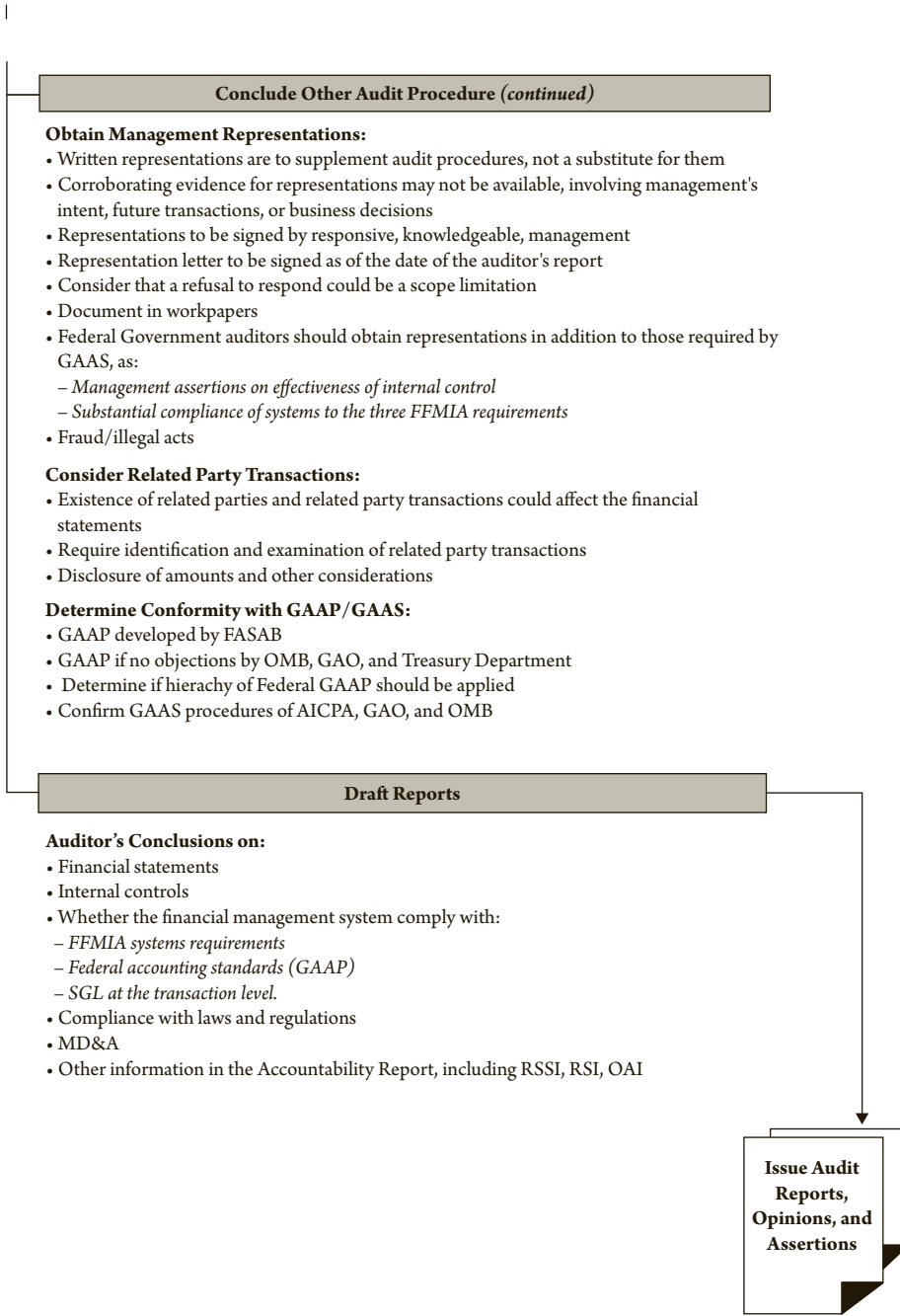
**Conclude Other Audid Procedures**

**Inquire of Attorneys:**

- Auditor to inquire of the entity’s counsel regarding contingent liabilities, uncertainties, litigation, claims, and assessments
- Inquiries and responses to cover the entire audit period through actual date of the auditor’s report
- If long lapse in counsel response, obtain subsequent update
- Consider if refusal to respond could be a scope limitation
- Document in workpapers

**Consider Subsequent Events or Transactions:**

- Occur after the balance sheet date, but before audit report issued
- If material, statements must be adjusted or disclosures made



Federal legislation, particularly several laws passed in the 1990s, required that audits of Federal Agencies, programs, and activities conform to the Yellow Book. The standards are to be applied by any auditor, regardless of their employer, when these standards are required by Federal law, regulation, agreement, contract, grant, or Federal Governmental policy, including:

- Federal, state, and local governmental internal auditors.
- Governmental Inspectors General and auditors.
- Accounting firms under contract to Federal departments and agencies and programs of Federal financial assistance.
- Certified public accountants and non-CPA auditors.
- Nonaudit personnel on Federal audit teams.

Further, GAGAS are not auditing standards imposed only on governmental entities. GAGAS are the auditing standards applied to audits of all Federal entities and non-Federal organizations that receive a designated level of Federal financial assistance, whether that assistance is obtained under a Federal contract or grant, loans or loan guarantees, Federal insurance programs, or Federal Government food commodity initiatives. With respect to the non-Federal entities, this universe of potential auditees includes organizations such as contractors, grantees, nonprofit organizations, colleges and universities, Indian tribal nations, public utilities and authorities, financial institutions, hospitals, and more.

The Yellow Book was initially promulgated by GAO in 1972 and has been revised and refined over the years. The December 2011 revision of the Yellow Book has incorporated all of the fieldwork audit and audit reporting standards and subsequent statements of auditing standards issued by the AICPA.

With the passage of the Sarbanes-Oxley Act in 2002 by Congress, the newly created Public Company Accounting and Oversight Board (PCAOB) became the legally empowered organization to set the auditing standards to be used by registered public accounting firms in preparing and issuing audit reports for publicly traded companies. When PCAOB promulgates these auditing standards, GAO has stated that it will monitor both the AICPA and PCAOB and clarify the GAGAS, as necessary.

## MANAGEMENT'S ASSERTIONS

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Under the Federal audit model and its *FAM*, a condition precedent to forming an audit opinion on financial statements is that the auditor must first obtain and evaluate evidential matter concerning the fairness of several management assertions that are implicit or explicit in the agency's financial statements and other reporting. Audits of financial statements, financial reports, and financial data provided by an agency's management are a process of independently examining, assessing, and reporting on several assertions by that

agency's management with respect to evidence supporting underlying classes of financial transactions, individual accounts, account groupings, and line items in financial statements and other financial reports.

In presenting its financial statements, transactions, and accounts for audit, agency management explicitly and implicitly makes or warrants that several assertions are true with respect to the reported data. For example, an agency's management assertions (as defined by the *FAM*) relate to:<sup>2</sup>

- *Existence or occurrence.* By this assertion, management warrants that all assets, fund balances, appropriation balances, and so on, are a true representation of a real, valid, existing agency assets, rights, and resources as of the date of the financial statement or other report. Further, this assertion warrants that all events, transactions, and accounts represented in financial statements and other financial reports are real, that is, these events occurred.
- *Completeness.* By this assertion, management warrants that no amounts, balances, transactions or disclosures are omitted from the financial statements and other financial reports, that is, the submitted data are complete and reflect "the whole truth and nothing but the truth."
- *Rights and obligations.* By this assertion, management warrants that all reported assets are owned by the agency and that all liabilities represent amounts properly owed, that will be owed, or for which a contingent liability and a future claim against the agency is probable.
- *Valuation or allocation.* By this assertion, management warrants that the values of all assets, liabilities, fund and budget authority balances, expenditures, expenses, and receipts are values and reported pursuant to Federal GAAP, as promulgated by FASAB, and that amounts have been fairly allocated (through depreciation or amortization or direct write-off, etc.) between the agency's statements.
- *Presentation and disclosure.* By this assertion, management warrants that the accounting classifications (i.e., presentations in the financial statements and other reporting) between current versus noncurrent, asset versus expenses, liabilities versus expenditures, and receipts versus revenues are properly reflected pursuant to the Federal GAAP, as promulgated by FASAB. Further, it warrants that all footnotes and other disclosures are adequate, not misleading, and not misstated by either the inclusion or the omission of significant or material facts.

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<sup>2</sup> The auditor may use these assertions or may express them differently, provided all the aspects of the assertions defined in AU-C 315.A114 are addressed (AU-C 315.A115).

Thus, the auditor must determine, through the audit evidence obtained and examined for each class of financial transactions, individual accounts, account groupings, and line items in financial statement and other financial reports, whether these assertions are fair representations. Through audit tests and procedures, the auditor must examine evidence that supports or rebuts each of these assertions.

## AUDIT TESTS, PROCEDURES, AND ACTIVITIES

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To obtain and evaluate evidential matter concerning the fairness of management assertions implicit or explicit in the agency's financial statements and other reporting, the Federal audit model and its *FAM* require the auditor to employ or conduct a variety of audit procedures.

Some audit procedures are more appropriate for evaluating and testing controls; others are better suited to test the fairness of transactions, account balances, and account groupings. Also, various authorities have described and grouped audit procedures and tasks by different categories. A listing of commonly applied audit procedures, audit tasks, or audit activities, all of which are required at some time by the Federal audit model and its *FAM*, includes:

Examine:	A reasonably detailed study by the auditor of documents or records to determine specific facts about the evidence
Scan:	A less detailed examination by the auditor of documents or records to determine whether there is something unusual that warrants further investigation
Read:	An examination by the auditor of written information to determine facts pertinent to the audit
Compute:	Calculation by the auditor, independent of the auditee
Recompute:	Recalculation by the auditor to determine the correctness of an auditee's earlier calculation
Foot:	The addition of columns of numbers by the auditor to determine whether the total is the same as the client's amounts
Trace:	The validation of details, as documents and transactions, in support of amounts recorded in ledger accounts and statements; a testing of details to summary data
Vouch:	The validation of transaction amounts recorded in ledger accounts and statements back to details, as underlying documents and supporting records; a testing of data from the summary back to details
Count:	A determination of assets or other items by the auditor through physical examination

Compare:	A comparison of information in two different locations by the auditor
Observe:	The personal witnessing of events, resources, or personnel behavior by the auditor
Inquiry:	Discussions or questioning by the auditor to obtain audit evidence
Confirm:	The receipt, by the auditor, of a written or oral response from an independent third party to verify information requested about the auditee by the auditor
Analytical review procedures:	The auditor's evaluation of financial information by a study of plausible relationships among financial and nonfinancial data, involving comparison of recorded amounts to expectations developed by the auditor <sup>3</sup>

Generally, or with few exceptions, the auditor's application or use of only one of these audit procedures to confirm or validate a particular management assertion would not be sufficient in itself. For the most part, more than one, and even several, of these procedures would be applied in a financial statement audit to confirm or validate a particular management assertion.

The determination of which audit procedure or combination of audit procedures should be employed by the auditor to most efficiently and effectively acquire necessary and sufficient audit evidence requires that decisions be made with respect to the *timing*, *nature*, and *extent* of the audit procedures required. These terms, used extensively throughout the *FAM* for a variety of testing and validation efforts, are generally defined in these ways:

- *Timing* of an audit procedure or audit tests relates to the decision as to *when* audit procedures and audit tests will be applied, for example:
  - a. At various interim dates of the period to be audited.
  - b. At the end of the period to be audited.
  - c. After the close of the period undergoing audit.
  - d. At some combinations of these times.
- *Nature* of an audit procedure or audit tests relates to the decision as to *what* audit procedures or combination of audit procedures should or will be applied.
- *Extent* of an audit procedure or audit tests relates to the decision as to specific *number* of transactions, documents, actions, and/or events that will undergo scrutiny by application of one, several, or the majority of the cited audit procedures.

In most instances, the *FAM* identifies the timing, nature, and type of audit procedures to be applied in the audit of a Federal financial statement. However, the Federal audit

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<sup>3</sup> Alvin Arens and James Loebbecke, *Auditing: An Integrated Approach*, 8th ed. (Upper Saddle River, NJ: Prentice Hall, 1999).

model and other models are somewhat less forthcoming with respect to prescribing the extent of, how much, or how many transactions, documents, actions, and events should be specifically tested. Decisions regarding the extent of testing are better left to the judgment of the auditor and the conditions and circumstances that the auditor encounters during the audit of a particular entity.

## AUDIT EVIDENCE

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Audit evidence must pass several tests to be acceptable in support of an auditor's conclusions and opinion. Such tests include relevance, validity, timeliness, lack of bias, objective compilation, and sufficiency. With respect to the sufficiency of audit evidence, this characteristic is judgmental and directly related to audit materiality, the adequacy of an agency's systems of internal controls, and the conditions and circumstances encountered during the audit.

In large audit entities, such as Federal Agencies, evidence can be manually or electronically prepared or can be a combination of both data processes. Also, the evidence may have been compiled by the Federal Agency or outsourced to a contractor, or be a combination of both methods.

From an auditor's perspective, the various types of audit evidence gathered can generally be categorized as:

- *Confirmation.* Evidence obtained by the auditor through direct written or oral confirmation with a party external to the auditee.
- *Observation.* Evidence obtained through direct, personal observations by the auditor.
- *Documentary.* Evidence obtained by the auditor's review of underlying accounting data and other corroborating forms and documents.
- *Mathematical.* Evidence developed by the auditor through the auditor's independent calculations and computations.
- *Analytical.* High-level comparisons of current-year data. These comparisons may include expected relationships between account balances and comparisons to prior years' balances. The comparisons typically take the form of ratios, trends, and time series analyses.
- *Hearsay.* Evidence obtained by auditor inquiry, perhaps even in the form of hearsay and gossip, that must be corroborated by other evidence.

The sheer size of Federal Agencies dictates that audit evidence be obtained through sampling in order to conduct an efficient audit. Thus, the Federal audit model and the Federal FAM describe both statistical and nonstatistical sampling, with considerable guidance being provided on statistical sampling approaches. Ultimately, the sampling approach must be dictated by the circumstances and conditions encountered in each audit. Both approaches do have their merits and demerits.



## SAMPLING

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When performing the audit of an entity, examining a selected number of transactions, generally referred to as sampling, is by far the most common audit technique. Sampling can take any of several forms, including statistical, nonstatistical, and judgmental. These sampling forms are discussed in further detail in later chapters.

The scientific statistical approach, quantitatively based and premised on theory of probability, is best when applied to populations:

- Of immense size.
- With minimal variances in size, in frequency, or periodicity.
- That are relatively homogeneous.
- With known errors or attributes.

A subjective or judgmental sampling approach is premised on auditor expertise in relation to what may be considered an adequate or sufficient sample. Subjective sampling is most efficient when a relatively large portion of the universe can be tested through the review of a small number of transactions.

## MATERIALITY

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Materiality, a basic important audit concept, is a concern to an auditor from two viewpoints: (1) when assessing an auditee's compliance with GAAP; and (2) when planning, conducting, and reporting the results of an audit made pursuant to generally accepted auditing standards and the Yellow Book.

Some standard setters have suggested specific dollar amounts, a percentage criteria, or specific conditions as being material. However, while these standards provide useful guidance, materiality remains a subjective concept requiring the exercise of auditor judgment in virtually every audit. Typically, these materiality issues warrant a separate examination, separate reporting, or different accounting and auditing emphasis, but these attempts to quantitatively proscribe materiality are admittedly arbitrary. In short, for accounting and auditing purposes, to be material, an item or issue must be significant, important, or big enough to make a difference.<sup>4</sup>

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<sup>4</sup> See W. Holder, K. Shermann, and R. Wittington, "Materiality Considerations," *Journal of Accountancy* (November 2003), for an excellent discussion of the importance of materiality considerations in financial reporting and auditing and the profound impact or complications arising from Financial Accounting Standards Board (FASB) 34, *Capitalization of Interest Cost* (issued 10/79) concerning the application of materiality to audits of governments.

### Accounting Materiality Defined

Financial statements can be materially misstated on two fronts: (1) for incorrect amounts and facts appearing in the statements, or (2) for amounts and facts that have been omitted from those statements. FASB's definition of *materiality* (also cited by the AICPA, FASAB, and GAO) is:

*Materiality*: The magnitude of an omission or misstatement of an item in a financial report that in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item. (FASB Concept Statement No. 2)

Materiality is not constant but relative, dependent on circumstances, and affected by the environment or industry within which the auditee operates. Amounts or factors material to the financial statements of one entity may not be material to another entity of a different size, with a different mission, or even for the same entity, but for two different fiscal periods. The concept of materiality is based on the premise that some amounts, matters, or issues, individually or in aggregate, are important enough to be fully disclosed and fairly presented in order for an entity's statements to conform with GAAP. Implicit in this concept of materiality is that lesser amounts and other matters and issues are not as important and therefore are immaterial for the purpose of an audit.

The AICPA, in its guidance relating to materiality, states "the auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of the users of the financial statements" (AU-C 320.4). Materiality, in this context, encompasses both a quantitative materiality (e.g., measured in absolute dollar amounts or percentage variances) and a qualitative materiality (e.g., an illegal payment, of minimal quantitative materiality, but that could have significant legal and ultimately large dollar consequences).

Materiality (of errors, misstatements, variances, changes, weak or overridden controls, etc.) is a concern in various phases of an audit and must be considered when:

- Planning an audit and designing the timing, nature, and extent of auditing procedures to be applied in an audit of financial statements.
- Performing and assessing the results of audit tests of controls, transactions, and classifications of transactions, accounts and account groupings, and line items of a financial statement.
- Evaluating the results of an audit to assess whether the audited financial statements, taken as a whole, are fairly presented in conformity with generally accepted accounting principles.

For audits made in conformity with GAAS and audit opinions on whether the financial statements are presented fairly in accordance with GAAP, the auditor must consider the effects of material misstatements and material omissions, individually and in aggregate, that have not been corrected by the auditee.

### **Pervasiveness of Materiality**

References to when and to what preparers and auditors of financial statements must apply the materiality criteria permeate the Yellow Book. Some examples from the Yellow Book are listed next.

- Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from violations of provisions of contracts or grant agreements that have a direct and material effect on the financial statements.
- Auditors shall report significant (i.e., material) violations of fraud, illegal acts, provisions of contracts or grant agreements, and abuse.
- When reporting deficiencies in internal control, auditors must identify reportable conditions that are, individually or in aggregate, considered to be material weaknesses.
- When circumstances call for the omission of certain information in the auditors' report, auditors must consider whether the omitted information distorts (i.e., is the included or excluded information material to report users?) the reported results or conceals improper or illegal acts.

### **Qualitative Materiality**

GAAS are rather specific in that auditors are instructed to conduct tests of controls, transactions, and account balances with the objective of detecting material quantitative misstatements. For audits involving governments and other public entities, often the qualitative issues emphasized by oversight boards and commissions create media focus.

Planning audit procedures with the objective of detecting material qualitative misstatements or material omissions in financial statements may not be cost beneficial or practical. Alternatively, GAAS instructs the auditor to *consider* qualitative factors that could cause seemingly quantitatively immaterial items to take on immense significance, or, in the language of GAAS, have qualitative materiality. Examples of qualitative issues having the potential to rise to a material quantitative matter might be noted or presumed instances of errors, illegal acts, fraud, thefts, misappropriation of funds and assets, defalcations, abuses, conflicts of interest, contract and grant terms, bond covenants, and the like.

**DISCREDITABLE ACTS**

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AICPA members must justify departures from governmental GAAS, as defined and described in the AICPA's auditing and accounting guidance for governmental entities. In the case of audits of governmental financial statements, Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits*, of the AICPA applies:

If a member [of the AICPA] . . . undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules, and regulations in addition to generally accepted auditing standards, he or she is obligated to follow such requirements. Failure to do so is an act discreditable to the profession in violation of rule 501 [of the AICPA Code of Professional Conduct], unless the member discloses in his or her report the fact that such requirements were not followed and the reason therefore.

The AICPA's GAAS describe measures of quality of audit performance, quality of exercised judgment during the audit, and the quality of audit objectives. In its many other promulgations for auditors, the AICPA continues to further define, describe, and illustrate these measures by delineating audit procedures, providing illustrations, suggesting audit programs, and offering guidance by many specific industries.

# 8 PLANNING THE AUDIT

## *Well Done Is Half Done*

At the outset of an audit, the auditor must have a clear idea of the audit scope to identify a process that will achieve audit objectives. Chapter 7 provided a summary of the *Federal audit model* that was jointly developed by the U.S. Government Accountability Office (GAO), the President’s Council on Integrity and Efficiency (PCIE), and the Office of Management and Budget (OMB). Exhibit 7.1, “Federal Audit Model—Agency Financial Statements,” displays, in a graphic format, the audit phases, procedures, and tasks for this model that are described in some 1,000+ pages of Federal guidance appearing in the *Financial Audit Manual (FAM)*, *Federal Information System Controls Audit Manual (FISCAM)*, and the *Standards for Internal Controls in the Federal Government*. Models and checklists are useful tools and can assist in the development of an effective audit approach and audit procedures; however, a model is not a plan.

The first auditing standard of fieldwork states, in part: “The auditor must adequately plan the work.” This simple, straightforward, and patently obvious statement, however, is no mere tautology. Planning is at the core of every successful audit; and conversely, failed audits can often be attributed to a poor, minimal, or partial plan. The breadth, depth, duration, and effectiveness of the planning phase is directly dependent on the auditor’s access to the Federal auditee’s personnel, the agency’s underlying data and information sources, and the experience of the audit team in conducting Federal financial audits. Indeed, as implied by the title of this chapter, an audit approach that is the product of a properly executed planning process is likely to result in a successful audit.

The focus of this chapter is planning. Exhibit 8.1 is a graphic depiction of the nature and specificity of the understanding that is needed to ascertain the conditions and circumstances related to understanding the “business” of a Federal Agency. It is a listing of many facts and characteristics of an auditee that, if known to the auditor, will provide a sound base to plan and execute an audit that addresses the accountability concerns of the government.

All of this beneficial information is already possessed, or at least more easily attainable, by internal auditors of government. Independent accounting firms, however, particularly for an initial audit, will not have access to this abundance of data and must make do with considerably less, relying also on extrapolations of the experience of the audit team with other government agencies.

**A. Understand Federal Auditee and Operations**

**Confirm Audit Scope**

- Laws and OMB regulations
- Financial, operational
- Government Auditing Standards
- Sarbanes-Oxley Act
- Treasury, GAO, and OMB regulations
- FASAB accounting standards

**Inventory General Audit Criteria**

- Government Auditing Standards
- Sarbanes-Oxley Act
- OMB Circular A-123
- OMB Bulletin 07-04
- FASAB accounting standards
- AICPA audit standards

**Determine Specific Audit Criteria**

- Beginning and end dates
- Reporting dates
- Type of audit:
  - Financial
  - Financial-related
  - Performance
  - Agency-specific
  - Contracts
  - Grants
  - Fiscal
  - Abuse or fraud review
- Audit reporting:
  - Opinions
  - Assurances
  - Other

**Learn Agency Organization**

- Origin, mission, and history
- Goals and objectives
- Location, organization, and strategies
- Inherent risks and fraud risks
- Communications
- Legislated outputs, outcomes, and targets
- Congressional hearings
- Select locations to visit:
  - Central or decentralized
  - Data processing/facilities
  - Outsourcing vendor sites
  - Significant/must visit

**Identify Agency Financing**

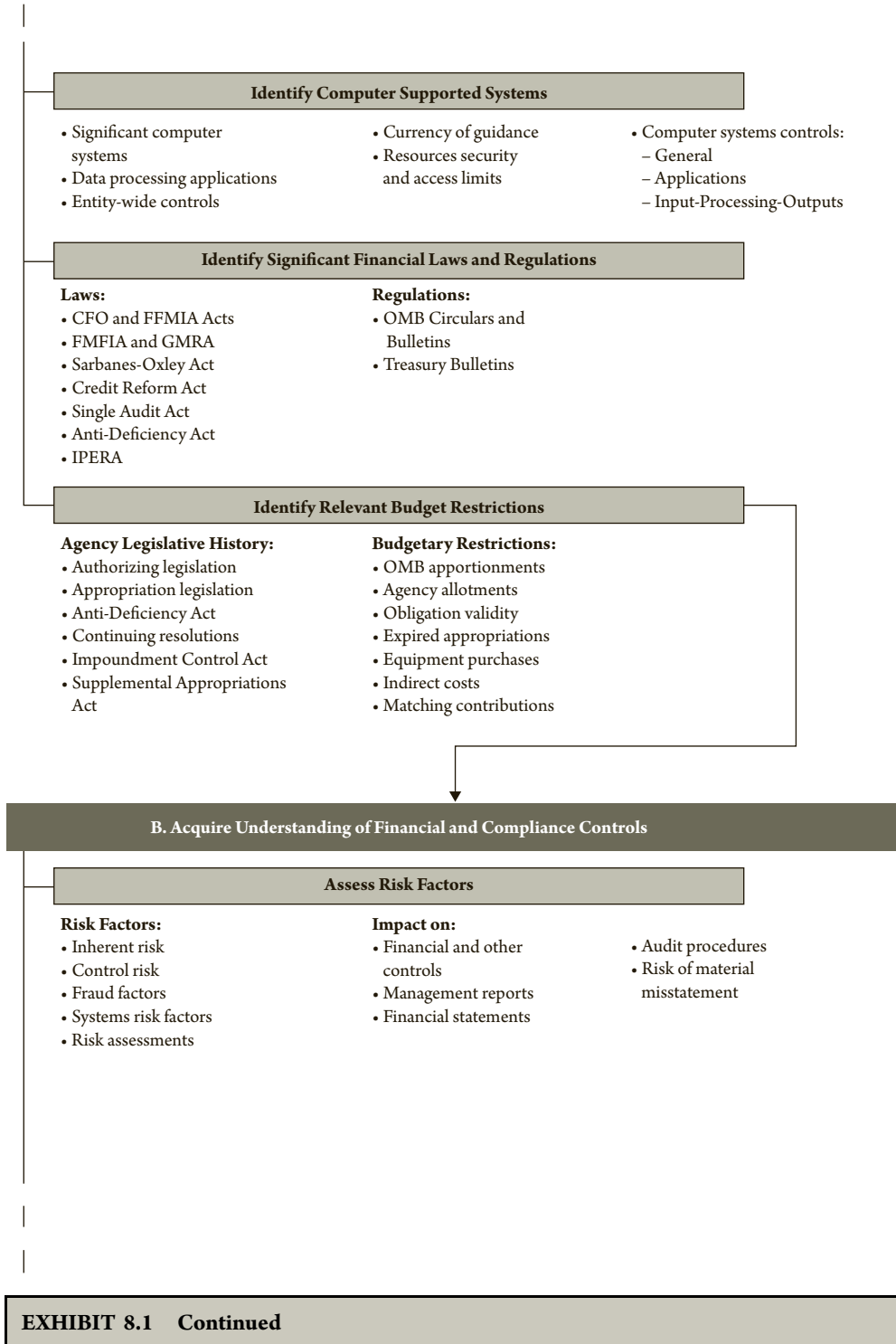
- Sources of Funding:**
- Appropriations
  - Revolving or working capital funds
  - Contract/budget authority
  - Allocations from others
  - Continuing resolutions

**Survey Agency Operations**

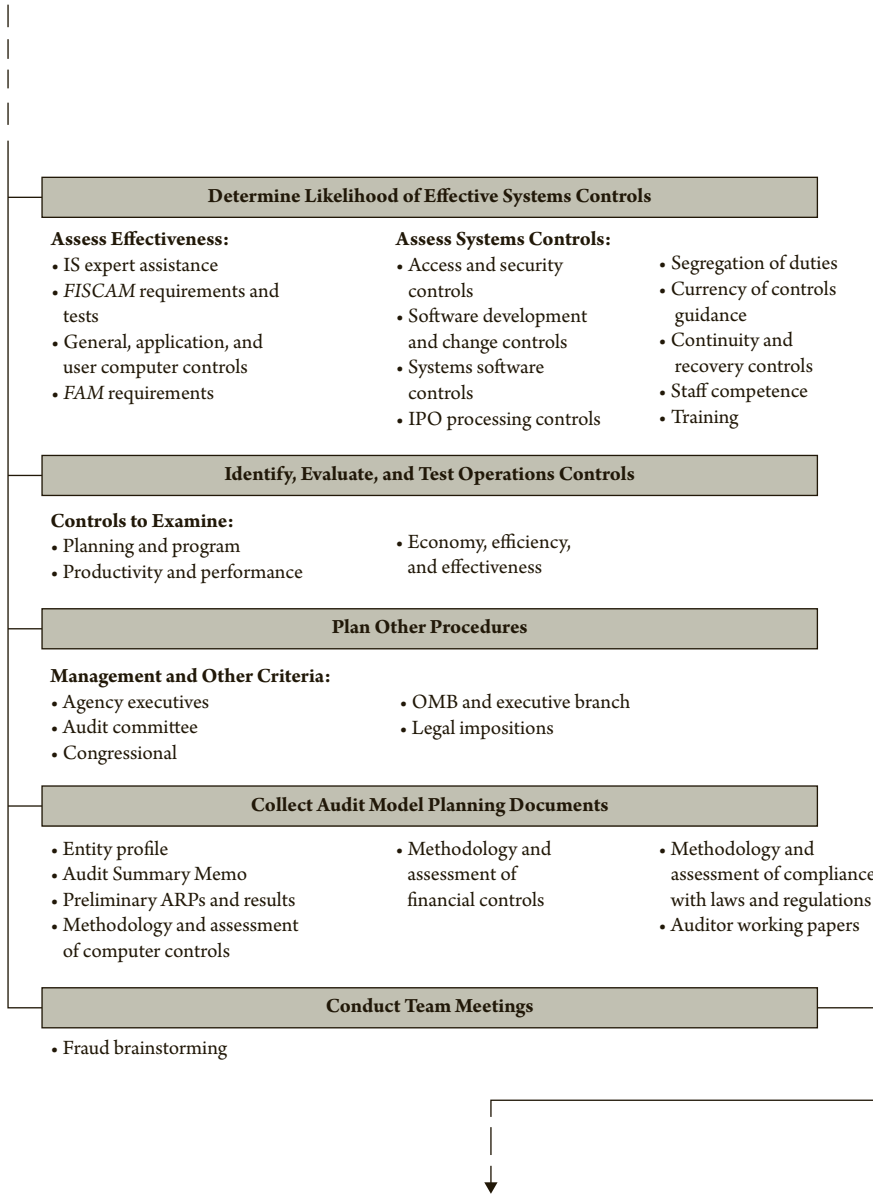
- Management and organization
- Factors impacting audit:
  - External
  - Internal
  - Internal controls
  - Financial and management systems
  - Automation status
- Past risk assessments

**EXHIBIT 8.1 Audit Planning Phase**

<b>Inquire into Systems and Documents</b>		
<ul style="list-style-type: none"> <li>• Transaction events and cycles</li> <li>• Account groups</li> <li>• Underlying documentation</li> </ul>	<ul style="list-style-type: none"> <li>• Status of automation</li> <li>• Types, timing, content, and number of reports</li> </ul>	<ul style="list-style-type: none"> <li>• Staff numbers and skills</li> <li>• Systems outsourcing</li> <li>• Other service-type entities</li> </ul>
<b>Review History: Financial and Other</b>		
<ul style="list-style-type: none"> <li>• News media “clippings”</li> <li>• Congressional hearings</li> <li>• Past financial statements</li> <li>• Budget issues</li> <li>• Single audit and other Federal reports</li> </ul>	<ul style="list-style-type: none"> <li>• Prior CPA and internal audit reports</li> <li>• Executive legislative reports</li> <li>• Investigative and consulting studies</li> </ul>	<ul style="list-style-type: none"> <li>• Results of citizens’ issue forums</li> <li>• Legal, statutory, and regulatory issues</li> </ul>
<b>Discuss Audit Protocol, Audit Support, and Audit Process</b>		
<ul style="list-style-type: none"> <li>• Management liaison</li> <li>• Type, extent, and timing of IG’s audit assistance</li> <li>• Type, extent, and timing of computer assistance</li> </ul>	<ul style="list-style-type: none"> <li>• Audit sites and locations to visit</li> <li>• Progress reporting</li> <li>• Records requirements and access</li> </ul>	<ul style="list-style-type: none"> <li>• Findings review process</li> <li>• Audit report recipients</li> </ul>
<b>Perform Preliminary Analytical Procedures</b>		
<ul style="list-style-type: none"> <li>• Current year ratio analysis</li> <li>• Prior period data and budgets</li> <li>• Other indicators and measures</li> </ul>	<ul style="list-style-type: none"> <li>• Recorded and expected values</li> <li>• Absence of fluctuations</li> </ul>	<ul style="list-style-type: none"> <li>• Compile ARP analyses</li> </ul>
<b>Determine Materiality Types and Levels</b>		
<p><b>Planning Materiality:</b></p> <ul style="list-style-type: none"> <li>• Financial statements</li> <li>• Timing, nature, and extent of audit procedures</li> </ul>	<p><b>Performance Materiality:</b></p> <ul style="list-style-type: none"> <li>• Transaction cycles</li> <li>• Line items</li> <li>• Accounts and account groups</li> <li>• Classes of transactions</li> </ul>	
<b>Identify Other Significant Factors, Cycles, and Applications</b>		
<p><b>Factors:</b></p> <ul style="list-style-type: none"> <li>• Statement lines</li> <li>• Accounts</li> <li>• Management assertions</li> <li>• RSSI, RSI, OAI</li> </ul>	<p><b>Transaction Cycles:</b></p> <ul style="list-style-type: none"> <li>• Budget cycle</li> <li>• Revenue cycle</li> <li>• Expense cycle</li> <li>• Procurement</li> <li>• Payroll cycle</li> </ul>	<p><b>Accounting Applications:</b></p> <ul style="list-style-type: none"> <li>• Payrolls and benefits</li> <li>• Billing, receivables, and receipts</li> <li>• Purchasing, receiving, and payables</li> <li>• Cost accounting</li> <li>• Inventories</li> <li>• Property and equipment</li> </ul>







**EXHIBIT 8.1 Continued**

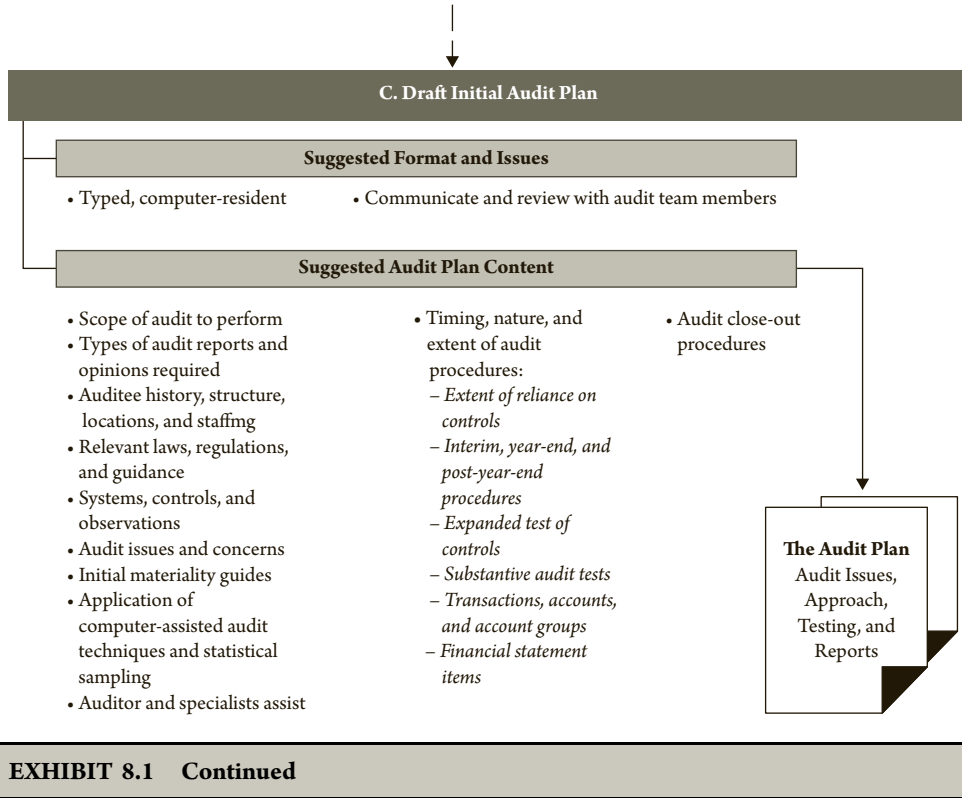


EXHIBIT 8.1 Continued

## PLANNING TO FILL THE KNOWLEDGE GAPS

The staffs of Inspectors General and other internal auditors employed by the Federal Government may not need to devote the same amount of time/attention to the planning effort as an independent accounting firm. Through their year-round, on-site proximity to their agency's operations, systems, and data, these professionals will have earlier acquired:

- An essential understanding of their agency's organizational structure
- An indication of management's competence.
- A knowledge of the relative effectiveness of internal controls over financial reporting.
- An awareness of the relative aggressiveness of their agency's management with respect to financial accounting and reporting and compliance with Federal laws and regulations.
- A working understanding of agency financial and other policies and procedures, and the operational effectiveness of the implemented internal controls over financial reporting.
- Some working knowledge and experience with their agency's financial, operational, human resource, payroll, procurement, and automated systems.

However, even these auditors must be cognizant of the fact that their knowledge and experience may only be as current as the last audit. Regardless of the auditor's level of prior knowledge, planning is necessary to address what has happened since he or she last left the site.

### **Independent Accounting Firms Must Plan Even Faster**

An independent certified public accountant (CPA), newly retained under contract, may have minimal or even no opportunity to perform planning activities even close to that of the agency's Inspector General (IG). Federal Agencies typically contract with an accounting firm to conduct audits for a set number of years, often up to five years. While rare, government agencies have been known to issue a request seeking proposals or bids for audits of their financial statements but provide minimal written or oral information or contact with agency executives and managers. In these instances, accounting firms that submit proposals might well be bidding blind. With this approach, the accounting firm accepts the risk that the audit could be considerably more difficult, take longer, and present problems never anticipated in its proposal or bid.

More commonly, however, after issuing a request for proposals, and before the date when firms are required to submit their bids, agencies will conduct a prebid conference to review the audit's scope, timing, and required reports. The Federal Agency may provide briefings to interested firms on topics such as these:

- Agency organizational structure
- Financial, information, and operational systems
- Extent of automation, if centralized or decentralized
- Implemented and applied internal controls over financial reporting
- Size of operational programs (staff, dollars, numbers of constituencies, etc.)
- Extent of geographic dispersion of the government activities

Occasionally, government agencies will permit interested firms to conduct walk-arounds at designated locations and facilities of the data processing operations and financial offices and may even permit interviews with key staff.

In addition, CPA firms may have the opportunity to review the audit parameters and history of the agency's past audits. Virtually every Federal Agency has a presence on the Internet with a Web site dedicated to a discussion of the agency's goals and accomplishments. This Web site normally includes a section on the agency's financial results, including audited financial statements for Chief Financial Officers (CFO) Act agencies and agencies choosing to be audited. The 2004 revision of OMB's Circular A-123, *Management's Responsibility for Internal Control*, requires every CFO Act agency to perform a detailed evaluation of its internal controls and report results to Congress. While these reports are not often made public, many times references to the results can be found in the auditor's report on internal controls, the agency's management discussion and analysis, and occasionally congressional proceedings. In addition, this information should be available to prospective

auditors during the proposal preparation phase of an audit. Clearly, examining a detailed review of the agency's site and obtaining whatever information may be available on the results of the application of Circular A-123 are essential to an understanding of the agency.

If an audit is to be properly planned, the auditor must have a sound understanding of the objectives of the audit and the general nature of the audit process. The purpose of Phase I, Planning, is to develop a preliminary understanding of the operations of the auditee including an initial review of the auditee's underlying systems of controls, accounting, and information, with particular emphasis on the level of the computerized state of these systems. The auditor's understanding of these systems is augmented further during each succeeding phase of the audit. During Phase I, the auditor begins to determine the general information needs for the audit. It is important to understand that audit planning is an iterative process. The auditor must be ready to reassess the audit strategy and, if necessary, revise the planned approach as new information on the audit or auditee surfaces as a result of audit procedures.

### **PLANNING PHASE: DO IT EARLY, DO IT CONTINUOUSLY**

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The availability of models, such as those developed by GAO, may cause auditors to wonder why planning is so important when working models and well-defined audit procedures are so readily available. The easy answer is that planning is required by OMB, GAO's *Government Auditing Standards* and the generally accepted auditing standards (GAAS) of the American Institute of Certified Public Accountants (AICPA). These criteria and guidance aside, planning is simply good auditing.

Poor planning, or lack of planning entirely, will most likely result in duplicate audit work, auditing the wrong data, delays in the audit itself, the omission of critical and possibly legally mandated procedures, and likely excessive audit costs. Another important reason to plan is audit risk mitigation or avoidance. Understandably, when any organization undertakes an initial audit of an auditee, the most experienced audit managers must be involved in the planning. No lesser commitment of audit management should be applied to each subsequent audit of that same auditee. Assuming that one year's audit will be the same as the audit for the prior year is highly risky and poor strategy. Prudence, legal and statutory requirements, and professional standards all dictate that each year's audit must be planned anew.

Models are useful. But, as with any model, it does not follow that the audit of every Federal Agency will conform to the execution of predetermined steps or procedures of a hypothetical model for application to a model Federal Agency. Rote execution of checklist procedures may leave the auditor with the false impression that a successful audit was performed. Model manuals, programs, and checklists are not a substitute for the audit judgment that is applied based on the conditions and circumstances of a particular Federal audit, each with characteristics different from other Federal audits.

The AICPA's risk assessments standards (Statements on Auditing Standards 104 to 111; see Chapter 6) clearly require that the auditor consider every audit unique when

executing the procedures/guidance set forth in the risk assessment standards. Obviously this does not preclude the auditor from considering what has happened in the past; indeed, considering what has occurred in prior years and determining whether the contributing factors have changed is an integral part of the risk assessment. It does, however, prevent the auditor from assuming that no changes have occurred and that whatever procedures that worked in the past will continue to work in the future.

Finally, in the interest of full disclosure, the authors acknowledge that this chapter and the remaining chapters on financial audits can provide the reader only with a conceptual roadmap—a model—of a process to conduct an audit of a Federal Agency. This text is qualified with the caveat that audit judgment must be prevalent and exercised at all times.

### **AUDIT MODELS, AUDIT CHECKLISTS: NO SUBSTITUTES FOR JUDGMENT**

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Every audit is unique, and audit procedures must be tailored to distinct circumstances. It is not possible to develop the perfect audit model or a universal checklist for all audit situations. While models are useful in planning, it does not follow that every audit consists of the execution of predetermined steps or procedures through each phase of the Federal audit model. Manuals, programs, and checklists are not substitutes for audit judgment. Many believe the audit failures that have marred commercial audits in the past are at least partly due to a failure to exercise the audit judgment that should have alerted the auditor to shortcomings in audit planning, execution of the audit approach, or application of appropriate accounting principles. Thus, the auditor should consult manuals, such as those developed by GAO; the auditor should even develop his or her own internal checklists to assist in the execution of audit procedures, so long as there is an understanding that the specific circumstances of the auditee will dictate what procedures are applicable (or whether any of the procedures in the checklist apply).

Planning an audit is not a “once and done” undertaking. Even the best plans must be refined, revised, and sometimes changed completely as the audit progresses and unanticipated activities, circumstances, and conditions are disclosed. This is particularly true for audits of the Federal Government, where, in addition to these factors, Congress could change its mind with respect to the desired goals, objectives, funding limitations, and even the programs of a Federal Agency from one year to the next.

A caution: The old plan is just that—it’s old! Don’t use a prior year’s plan again for the coming year or for a new auditee. Plan each audit anew and update that plan often.

### **UNDERSTAND THE FEDERAL AUDITEE: EACH IS UNIQUE**

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Armed with a sound understanding of the audit process, as discussed in Chapter 7, the auditor can proceed to understand the unique characteristics of the auditee to develop an audit approach that addresses the specific circumstances of the auditee.

### Understand the Agency—Learn Its Business

The need to understand the auditee's business is a well-established concept in commercial auditing. Clearly, if the auditor does not understand the auditee's business, can the auditor understand how the business earns its revenues, invests its resources, and makes money? Further, without this understanding, how can the auditor identify significant accounting cycles and processes involved in the production of the financial statements that are the subject of the auditor's opinion?

To some, however, the use of the term *business* as a reference to a Federal Agency may seem inappropriate or strange, as almost no Federal Agency earns revenues, and there is usually no profit motive. Many think of Federal Agencies in terms of missions, goals, and objectives that are subsets of the overall mission (e.g., good health, national defense, or social security); but commercial enterprises can also be defined in terms of mission, such as maximization of shareholder wealth or profits or the more "politically correct" optimization of customer service. Additionally, the mission itself has supporting goals, such as sales goals, investments in product research, human resource quality-of-life issues, and participation in community-related social programs, all of which ultimately contribute to the achievement of the enterprise's mission.

But, as used in this text, the term *business* encompasses not only missions, goals, and objectives but also the processes, both logical and physical, that enable any organization to achieve its mission. Thus, similar to audits of a commercial enterprise, by understanding the agency's business, the auditor will understand how the:

- Federal auditee operates.
- Agency is funded (e.g., appropriation, budget or contract authority, payment for services rendered, third-party fees, etc.).
- Agency invests its resources (and existing restrictions on the expenditure of resources).
- Agency measures performance (a substitute for making a profit).
- Combination of these factors is likely to motivate agency management.

### Assess the Agency's Control Environment: Initiate Risk Analysis and Document an Audit Strategy

Closely related to the understanding of the auditee's business is the need to understand the auditee's control environment. The control environment reflects the overall attitude, awareness, and actions of management and others concerning the importance of control and the emphasis given to control in the auditee's policies, procedures, methods, and organizational structure. The control environment reflects management's attitude toward the development of accounting estimates and its financial reporting philosophy and is the context in which the accounting system and internal controls operate.

Obtaining an understanding of the auditee's control environment assists in the identification of factors that may have a pervasive effect on the risk of errors of audit

importance in the processing of transactions and on the judgments management makes when preparing financial statements. An earlier understanding of the auditee's business facilitates the identification of factors to look for in the assessment.

Although the existence of a satisfactory control environment does not guarantee the effectiveness of specific application controls over the processing of data, it can be a positive factor in assessing the risk of errors. An effective control environment provides a basis for expecting that accounting systems tested at an interim date will continue to function properly during the entire period under audit. Conversely, perceived weaknesses in the control environment may undermine the effectiveness of specific controls and can thus be a negative factor in the assessment of the risk of errors of audit importance. Therefore, assessing the overall effectiveness of the control environment helps to establish the level of professional skepticism required for the audit, influences the likely nature and extent of audit testing, and is a factor in determining how early in the year tests can be performed. The control environment is determined by a combination of three elements:

1. Management's control consciousness and operating style
2. Control mechanisms established by management that provide the framework in which specific controls and accounting processes operate
3. Those factors that influence management's attitude about the conduct and reporting of operations and the importance of controls

In order to understand and assess the control environment, each of the three elements just listed, and their interrelationships, must be considered. Significant deficiencies in any one of the elements may undermine the effectiveness of the others.

### **AUDIT TECHNIQUES AND SOURCES OF INFORMATION: HOW TO ACHIEVE AN UNDERSTANDING OF THE AGENCY**

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Since every auditee is unique, how the auditor develops an understanding of the auditee depends on the nature or purpose for which Congress established the Federal Agency as well as information and data about the agency that are readily available. In general, sources of information will fall into one of six categories:

1. External guidance issued by standard setting organizations
2. Internally developed guidance issued by the Federal Agency (including both cabinet and subcomponent levels)
3. Audit and consulting reports and working papers
4. Internally developed documentation
5. Historical and interim accounting information
6. Management and operating personnel

**External Guidance: By Regulators and Standard Setters**

Every agency must comply with rules issued by third parties. With respect to Federal Agencies, the nature of the third-party rules is extremely diverse, emanating from constitutionally created executive, legislative, and judiciary branches of government and from nongovernment trade organizations, such as the AICPA. In developing an understanding of the auditee, an auditor will typically consult the following:

- Agency enabling legislation
- Current budgetary guidance
- Oversight agency and standard-setting organization guidance including:
  - OMB
  - GAO
  - U.S. Department of the Treasury
  - Federal Accounting Standards Advisory Board (FASAB)
  - Financial Accounting Standards Board (FASB)
  - AICPA

In general, external guidance is designed to define the parameters and boundaries within which the auditee must function and will identify accounting principles and internal control practices and procedures that the auditee must follow. As a general rule, non-compliance with this external guidance will likely affect one or more of the three auditor's reports (financial statements, internal controls, and/or compliance with laws and regulations).

**Internal Guidance: By Agency, Cabinet, and Subcomponents**

Most Federal Agencies issue additional guidance related to their own accounting procedures and internal controls and data processing, whether it is a manual or a computerized process. Although this guidance is frequently reflective of higher (i.e., external) authority or guidance, agency-generated guidance is often useful in informing the auditor of unique characteristics and concerns of the auditee. Noncompliance with this guidance is likely to affect the auditor's report on compliance with laws and regulations (depending, of course, on the magnitude of noncompliance and the likely impact on the financial statements).

**Audit and Consulting Reports and Working Papers**

Not to be overlooked when attempting to understand an agency's financial, compliance, and computer processing controls are reports by agencies such as GAO and the Office of the Inspector General, which report on issues and problems affecting the auditee. In addition, the auditor should consult prior years' financial audit reports and the supporting working papers. A review of records, when available, is an invaluable source of information to any auditor. While it is important to note that a review of these reports is



not a substitute for the auditor's own compliance with the second standard of fieldwork (developing an understanding of internal controls), these reports are nevertheless invaluable in improving audit efficiency, guiding the audit effort, and identifying audit and accounting issues that may significantly impact the auditor's assertions.

Like audit reports, consulting reports can also provide valuable insights on issues affecting the auditee, particularly in regard to the development of new systems, planned system enhancements, and progress achieved in addressing internal control weaknesses identified in prior audits. However, the auditor should also consider that, while subject to professional standards, consulting reports are not governed by the same independence rules as audit reports.

### **Internally Developed Documentation**

The previously addressed sources of information assist the auditor in identifying the rules that the auditee is subject to as well as internal control and accounting issues that may affect the audit. Internally developed documentation, such as accounting and user manuals, policy and procedures manuals, and desk instructions, provides information on how (or whether) the auditee complies (or attempts to comply) with rules and regulations and provides (or attempts to provide) adequate accounting and operating controls to support the development of financial statements that are fairly stated in accordance with generally accepted accounting principles (GAAP).

By providing information on relevant accounting cycles and processes as well as existing controls, this documentation is essential to the auditor in developing a sufficient understanding of internal controls to guide planning, development, and later execution of relevant audit procedures, as required by the second standard of fieldwork.

### **Historical and Interim Accounting Information**

A review of interim financial information (preferably at the trial balance level) provides the auditor with immediate insight into a number of audit-related considerations, including:

- What accounts are material/significant to the audit.
- What systems are likely to impact those accounts and, therefore, merit careful documentation and audit consideration.
- The types of processes (e.g., recurring or routine, nonrecurring or nonroutine, and processes requiring estimates) that are likely to support the accounting cycle for each of these accounts (and thus the type of audit procedures that are likely to be required).
- Where audit issues are likely to surface and what internal control practices (e.g., reconciliation procedures, segregation of duties) the auditor should look for, as the presence (or absence) of these procedures will directly impact internal control and audit risk.

In addition, the review of interim data is essential to the execution of analytical procedures, as required by GAAS, during the planning phase of the audit. Analytical procedures will quickly reveal areas of potential audit significance by highlighting, for example, major changes in account balances from prior years or a reversal in expense or revenue trends.

The AICPA, within its GAAS, as well as the GAO within its *Government Auditing Standards*, mandate that auditors perform analytical review procedures (e.g., make comparisons and trend and variance analyses, perform modeling, etc.) of financial statements, portions of financial statements, funds, group of accounts, individual accounts, and financial transactions. Analytical procedures consist of the evaluation of financial information by a study of plausible relationships among both financial and nonfinancial data. As a rule, the auditor applies these techniques four times during an audit:

1. To assist the auditor in planning the nature, timing, and extent of other audit procedures to obtain evidential matter for specific statements, reports, accounts, or classes of transactions
2. As a substantive audit test to obtain evidential matter about particular assertions related to classes of transactions
3. As a substantive audit test to obtain evidential matter about particular assertions related to account balances
4. As an overall review of the financial information during the final review stage of an audit

When well executed, analytical review procedures will, in most instances, identify conditions such as unusual transactions and events, material accounting changes, significant operational changes, large random fluctuations, and material misstatements, all of which should be known to the auditor as early as possible. Analytical review procedures should not be limited to financial data. Revealing, informative conclusions that could impact the audit could result from analyses of numbers and grade levels of employees, organization charts, square footage and equipment statistics, persons or organizations on tax rolls, populations of citizens served, numbers and types of computers, other equipment, and inventories owned, and the like. In short, analytical procedures, combined with the review of interim accounting information, are efficient means of identifying areas that bear immediate attention by more senior audit personnel.

### **Management and Operating Personnel**

In theory, an auditor could obtain all necessary information from formal guidance and/or documentation and reports, as discussed. However, in practice, there is no substitute for the additional insight into current operating conditions that can be obtained only directly from the management and operating personnel responsible for the daily execution of the accounting function and other activities that ultimately impact the process of developing financial statements that are fairly presented.

As with any other audit activity, the auditor must exercise judgment in achieving a proper balance of formal documentation and information directly from the auditee's personnel. At all times, the auditor must be cognizant that the auditee's employees have daily duties and responsibilities that must be accomplished no matter how pressing the information needs of the audit are. Thus, ideally, the auditor should obtain as much information as possible from existing formal documentation and consult auditee personnel only to fill in documentation gaps and obtain a final verification of the auditor's understanding of the systems, as documented in the auditor's working papers.

Often, however, formal written documentation is outdated or fragmented, consisting of operational memos and desk instructions that have not been properly controlled or compiled, or both; that have significant gaps in connection with the documentation of internal controls; or, sadly, that are too illegible and/or too hard to follow to be effectively utilized by an auditor who has not spent years working with the auditee's systems.

The auditor's need to consult auditee personnel to complete the documentation of systems is frequently a source of friction between auditor and auditee. It is the auditor's responsibility to explain plainly but diplomatically why, despite the existence of formal documentation, it is necessary to interview accounting and operating personnel to complete the documentation and assessment of internal controls.

A later discussion in this chapter addresses other matters of importance in connection with direct dealings with auditee personnel.

### **Circular A-123 Documentation**

Auditee-developed documentation pursuant to Circular A-123 requirements is potentially a major source of information regarding the auditee's internal control environment as well as its systems of internal controls, control deficiencies, and ongoing corrective action projects likely to impact the audit. A fully compliant Circular A-123 report provides the auditor with useful information that was not present prior to the inception of the revised circular and adoption of the related appendices. While the documentation and conclusions in the auditee's Circular A-123 report cannot be accepted without subjecting it to verification procedures, it does provide a valuable first insight into the auditee and potential audit issues that can be expected during the execution of the audit.

### **Audit Techniques: Documenting the Understanding**

The information discussed so far is essential for the development of an audit approach that will be outlined in an audit plan. It is also necessary for documenting the auditor's compliance with the government's requirements on assembly of working papers related to planning and the auditor's internal controls assessment, posed by both the AICPA's GAAS and GAO's *Government Auditing Standards*.

Documentation can take the form of narratives or flowcharts. Narratives consist of memos summarizing key aspects of the systems of internal controls. Flowcharts are graphic

depictions of the flow of transactions and the controls that transactions are subjected to as they proceed through each applicable accounting cycle or process. Documentation will also include copies of critical control features (e.g., computer input screens, purchase orders, and time sheets) and may also include copies of selected sections of user and policy manuals.

A more detailed discussion of the documentation of accounting cycles is addressed in Chapter 9 with the evaluation of internal controls and the execution of detailed risk assessments.

### **PUT THE UNDERSTANDING TO USE: DEVELOP THE INITIAL AUDIT APPROACH**

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At this point in the planning process, the auditor should have obtained the necessary information to develop an initial audit plan to guide future audit efforts. In summary, the procedures discussed earlier should enable the auditor to achieve these planning objectives:

- Identify areas of audit significance, including potential problem areas.
- Catalog all applicable Federal requirements, including OMB Circulars/Bulletins, as appropriate.
- Consider, catalog, and update auditor's understanding of the auditee's internally developed standards and procedures used to monitor compliance with internal requirements and Federal standards.
- Assess the degree of risk and the nature of errors that could result from accounting estimates and other subjective areas.
- Identify unusual or unexpected transactions.
- Identify significant accounting issues.
- Assess the degree of difficulty that may be encountered in gaining sufficient audit evidence.

Certain areas of significance to development of the audit plan are discussed in more detail next.

#### **Establishing Materiality: A Key Determination Requiring Audit Judgment**

While materiality is often thought of as an amount or percentage, accounting literature, including that of GAO and FASB, defines the word in terms of magnitude and a threshold so that materiality refers to an error beyond a certain level or threshold that would likely result in the users of the financial statements being misled.

There is a reason why the terms *magnitude* and *threshold* are used instead of an absolute amount in defining materiality. All authoritative guidance agrees that absolute amounts alone cannot define materiality. Rather, other facts and disclosures could, if misstated beyond a tolerable threshold, also mislead the reader of the financial statements. In the case of Federal financial statements, GAO adds a new dimension by stating that the

nature of government and the public trust will often require that the auditor consider a lower materiality threshold than would apply to a commercial enterprise.

In practice, auditors will usually quantify materiality at two levels:

1. An overall level, as it relates to the financial statements taken as a whole, and typically referred to as planning materiality
2. An individual account or group of accounts level—where the auditor typically allocates a lower materiality threshold covering these items

Planning materiality is the auditor's preliminary judgment of what amount or variance would be significant to an agency's financial statements, keeping in mind GAO's more stringent threshold. Planning materiality judgments are used to develop the initial overall audit approach, probable audit procedures, and possible audit tasks, but they must be reevaluated at the conclusion of the audit. Auditors should consider the financial statement impact of both the total amount of known and the total amount of likely uncorrected errors as well as the effect of these on qualitative considerations that cannot be expressed in absolute amounts.

As a general rule, materiality at the account level is set so that the probability is remote that the total of audit differences in all accounts will exceed the auditor's initial judgment regarding planning materiality. By allocating a lower materiality threshold to individual accounts or groups of accounts, the auditor is able determine the extent of testing necessary at the account balance level. The auditor is required to document the steps taken to consider materiality. GAO's *FAM* (July 2008 revision) suggests that planning materiality should be set at 3 percent of the materiality base (paragraph 230.11) and that design materiality (e.g., materiality at the account level) be set at one-third of planning materiality (paragraph 230.12). The materiality base is defined as either total assets or total expenses depending on the nature of the auditee's operations/mission and the auditor's judgment (paragraph 230.09).

### **Identifying Significant Accounts: Areas of Audit Significance and Potential Audit Issues**

Planning an effective audit approach requires an accurate assessment of the likelihood that errors of audit importance may have occurred in the information subject to audit. Doing this requires the auditor to identify the significant accounts or groups of accounts that could potentially include errors of audit importance. *Errors of audit importance* include the following:

- Those that individually or collectively could have a material effect on the financial statements being examined
- Other matters that, though not material from a dollar aspect, could adversely affect the audit if such matters were to remain undetected or not be reported by the auditor (e.g., illegal acts, fraud, conflicts of interests, unauthorized management actions, antideficiency violations, and fiscal improprieties)

It is critical that, as soon as possible, the auditor identify the significant accounts and account groups as well as the related audit risks that must be examined in greater detail during the audit. This technique of quick, early identification of potential audit issues and risks provides for the optimal allocation of junior, senior, and management personnel and provides essential input into a more strategic planning of the audit approach. These quick, early determinations should not be viewed as final, never to be revisited, or changed. On the contrary, these determinations should be examined and reexamined up until the date the audit report is delivered.

### **Establishing Rules of Engagement: Administering and Managing the Audit**

Despite his or her best intentions, the auditor is in an adversarial role during the execution of the audit. For this reason, the auditor must strive to establish, as early as possible, well-defined channels of communications and working relationships with executives, managers, and staff of the Federal Agency. To minimize friction, which seems to accrue as a by-product of audits, it is important that agreement be reached with the auditee regarding the protocol to be followed during audit execution. In general, it is recommended that the auditor:

- Hold early protocol governing discussions and conduct interviews with agency management, senior and technical accounting, systems, other operating personnel.
- Discuss, to the extent permitted by those arranging for the audit, the audit approach and procedures that will likely be followed to verify audit findings.
- Identify the protocol or process to be followed for documentation requests.
- As soon as possible in the planning phase, obtain a listing of all documentation and other supporting competent evidential matter that will be required for the audit. This documentation list should be as detailed and exhaustive as possible to assist the auditee in the execution of the audit plan. Developing a truly comprehensive list may be virtually impossible during first-time audits. First-time audits of large complex organizations are, arguably, unique to the Federal Government. It is important to note that the term *first-time audit* refers to the auditee being audited for the first time, not to the first time a particular auditor audits the auditee. (The latter is the more common first-time audit condition in both the private and Federal sectors.) When auditing an entity previously audited by a predecessor audit, the successor auditor has access to prior-year working papers and prior-year audit history, thus significantly reducing the uncertainties that surround a true first-time audit.
- Establish an agreed-upon timetable to execute the audit, including the timing of audit procedures, expected availability of auditee personnel, and agency production of required documentation for auditor examination.
- Introduce the audit professionals who will participate in the audit as well as the protocol that will be followed when presenting newer auditors to the team. Given

the current risks and security concerns faced by the Federal Government, this is a critical consideration in all Federal audits.

- Set and adhere to a schedule of timing and frequency for progress meetings, status meetings, and reporting. This is an important part of keeping the auditee apprised of progress as well as of potential problems.
- Provide disclosure and disposition of findings (including procedures to be followed) to help the auditee validate the factual understanding of audit and accounting issues.
- When applicable, review the procedures and requirements with the auditee's audit committee, should one exist.
- Determine the representations that must, and will, be requested of auditee management, its accounting, and legal counsel.
- Verify any AICPA and GAO requirements regarding the communication of audit findings to nonmanagement personnel, such as oversight agencies and individuals/organizations charged with governance.

This listing is not all-inclusive and once again serves as a warning of the need to tailor procedures to the specific characteristics/circumstances of the auditee as appropriate. An audit approach that is appreciative of and responsive to the auditee's operating needs is essential to the successful execution of an audit.

When developing a communications protocol, the auditee may pose restrictions and request that information or meetings with operating personnel be routed through a member of management. In general, management is probably best suited to point the auditor to those individuals who are most able to provide accurate, up-to-date information. As a result, this type of restriction is not unusual, since auditee personnel have always been leery of auditors acting on incomplete or misleading information. Additionally, when auditing Federal Agencies, there must be a continual concern and appreciation on the part of the audit team with the agency's need to comply with legally imposed security regulations and restrictions.

Thus, the auditor should not always be distrustful of restrictions imposed by an agreed-upon protocol. Yet the auditor also must be careful that, in practice, the audit administrative protocol does not result in restrictions to the required audit scope. There will always be certain individuals or aspects of the audit that require direct auditor access, and the protocol cannot limit this access. Once again, the auditor must exercise judgment to achieve a proper balance between audit needs and the need to avoid disruption of the auditee's operations.

#### **AUDIT TEAM MEETINGS: WHAT DO WE THINK?**

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U.S. Auditing Standards—AICPA Clarification and Recodification (AU-C) 315.11, *Understanding the Entity and Its Environment*, and AU-C 240.15, *Consideration of Fraud in a*

*Financial Statement Audit*, require audit team meetings to discuss the risk of misstatements in the financial statements (based on individual experience as well as findings developed during the initial planning phase) and the possibility of fraud covering both the preparation of financial statements and fraudulent activities that may lead to misstatements in the financial statements.<sup>1</sup>

It is anticipated that the topics can be combined into one meeting. The meeting provides a good opportunity for experienced auditors to share their insights with more junior team members, but perhaps just as important, it allows the different members of the team, including the more junior members, to provide different insights into the issues. It is important that the meeting take the form of a controlled brainstorming session allowing for the free flow of observations and ideas regarding the control and audit risks as well as potential procedures to be applied to facilitate execution of the audit.

The guidance is somewhat vague regarding the composition of the meeting except for stating that key members of the team, including the auditor with ultimate responsibility, should attend the meeting. A number of firms involve all members of the audit team, including junior, inexperienced auditors, in the discussion. Besides having the advantage of avoiding second-guessing on the part of future peer reviewers regarding whether all relevant personnel were included, the exchange of ideas is likely to uncover potential future stars as well as training needs of the more junior personnel.

## **DOCUMENTING THE PLANNING PHASE: DEVELOPING THE ACCOUNT RISK ANALYSIS AND THE AUDIT STRATEGY/AUDIT PLAN**

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The objective of the survey, inquiry, limited tests, walkthrough, and data gathering efforts discussed earlier provide the necessary input to develop and document the overall audit strategy. This strategy can be defined by the completion of two documents, the account risk analysis (ARA) and the audit plan.

### **Account Risk Analysis: How Are Things in the Back Office?**

The purpose of the ARA is to:

- Identify and document significant accounts, line items, required supplementary stewardship information, and related assertions being made on each of these.
- Identify and document accounting systems and processes that affect the different elements being asserted on

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<sup>1</sup> The AICPA is currently engaged in a clarification and recodification effort that will replace the current AUs. The term *AU-C* refers to section numbers that have replaced AUs. Once this effort is completed (anticipated for 2014), all references will revert back to AU.



- Propose an audit plan that:
  - Identifies potential deficiencies and risks that may affect these elements asserted on.
  - Specifies the procedures that will be performed to determine and evaluate the risks.
  - Develops procedures that reduce the audit risk to a tolerable level.

*FAM* Section 290 on documentation provides extensive guidance on documenting the auditor’s account risk analysis. *FAM* Section 395 I proposes a tool (“Account Risk Analysis Form”) that documents the analysis. Together with the form at *FAM* Section 395 H (“Specific Control Evaluation Worksheet”), it is an invaluable tool.

The Appendix to this chapter contains copies of these forms.

### **Audit Strategy/Audit Plan: What’s Next and Why?**

The audit plan, or the product of the planning phase, must describe both technical audit requirements (the audit strategy) and engagement execution/administration issues. The audit plan assists in providing a consistent framework or thought process, which is a strategy that should be applied throughout the audit. The audit plan will describe the financial conditions and operating environment of the auditee and highlight potential audit issues while incorporating relevant input from prior audits and from management. The audit plan will identify staffing requirements, including specialists, and provides for the timely involvement of more senior personnel responsible for the execution of the more technical aspects of the audit as well as quality control.

In developing the audit strategy, the auditor takes into account these items:

- Audit scope (e.g., full financial audit, audit only of specific financial statements, etc.)
- Basis of reporting (e.g., GAAP, other comprehensive basis of accounting, etc.)
- Audit deadlines (specific deliverable dates if applicable and audit deadlines)
- Communications protocol
- Multiple locations if applicable
- Unique characteristics of the auditee
- Materiality levels
- Other factors that typically are determined by the nature of the auditee’s business

As noted in GAO’s *FAM* Section 290.05, audit plan/audit strategy documentation includes, among other considerations, these items:

- Descriptions of accounting cycles and systems memoranda.
- Results of preliminary analytical procedures.
- The process and rationale behind the planning and design materiality and tolerable misstatement established during planning, including the amounts and nonquantifiable considerations affecting the materiality determination process.

- Methodology used to assess information systems (IS) controls. For Federal audits, it is recommended that the auditor follows GAO's *FISCAM* guidance. If firm-unique methodology is used instead, it would be wise to document how this methodology meets or exceeds *FISCAM* guidance.
- Laws and regulations that affect the auditee and that the auditor must consider in its compliance report (including OMB-required laws and regulations).
- Detail budget restrictions (particularly relevant to ensure the auditor documents and reports events of noncompliance with antideficiency regulations).
- Level of audit assurance. *FAM* guidance requires justification of a level assurance below 95 percent (error rate greater than 5 percent).
- Audit team discussions covering potential for material misstatements (AU-C 315.11) and fraud (AU-C 240.15).
- The auditor's assessment of overall inherent risk including:
  - Risk factors influencing the auditor's conclusion.
  - Major risks associated with the auditee, including risks unique to the entity.
  - Impact of the internal control environment (covering effectiveness of self-assessment efforts, such as Circular A-123 compliance) on financial statement and audit risk.
  - Description of the risk.
  - Cycle/accounts/assertions affected by the risk.
- Fraud risk.
- Initial assessment of compliance with Federal Managers' Financial Integrity Act (FMFIA) and Federal Financial Management Improvement Act (FFMIA), if applicable
- Impact of information technology, including documentation of system design, related risks, impact on control environment, and preliminary audit evaluation of risks associated with significant information systems. Where extensive documentation is necessary, this information typically is presented in an appendix or separate document (referenced by the audit plan/strategy documentation).
- When applicable:
  - Operations controls to be tested.
  - Additional audit procedures.
  - Locations to be visited included procedures to be performed, rationale for selection, anticipated rotation procedures, and so on.
- Assigned personnel (including specialists when applicable).
- Deliverable deadlines, audit milestones, and reporting deadlines (including draft and final reports).
- Management letter milestones (if different from the audit reports).
- Use of IG/internal audit personnel.
- Extent of assistance from operating personnel.

These other potential audit issues should be considered (unless fully disclosed in the ARA documentation discussed earlier):

- Significant accounts
- Potential high-risk areas
- Significant nonroutine and estimation processes involved in the development of the financial statements
- Unique accounting requirements
- New or developing accounting systems
- When applicable, progress made in addressing internal control issues identified in past audits
- Application of computer-assisted audit techniques and statistical sampling
- Cross reference to the ARA sections containing audit plans and procedures (audit programs), covering:
  - Internal controls
  - Additional risk assessment procedures (pursuant to testing results)
  - Compliance testing
  - Substantive testing
  - Planned analytical procedures
- Description of the auditee's operations (entity profile) including:
  - Mission
  - Location(s)
  - Interim financial information
  - Current-year budget information
  - Number of employees
  - Organization chart

In developing an audit strategy/audit plan, the auditor must design an audit approach that, of necessity, will and must include assumptions regarding the auditee's internal control environment and internal control structure. Once again, one of the realities of auditing must be underscored: audit planning is present in every phase of the audit. The initial phase of the audit is planning intensive, but the completion of Phase I does not mark the end of planning.

In fact, during the conduct of an audit, the audit strategy is continuously reexamined, refined, revised, and changed as the specific audit procedures performed shed additional light on existing conditions and circumstances and, in particular, those related to the internal control structure and significant accounting, auditing, and financial reporting issues. The technical audit approach must provide for planning throughout the execution of the audit and allow for the flexibility to alter plans as the audit progresses.

This is particularly true of a first-time audit, where there is no history to guide the initial planning effort. In fact, in a first-time audit, with only preliminary and limited

information on internal controls, there is no clear distinction between the planning phase and the initial procedures of the internal control phase of the audit, where the auditor obtains additional information about the auditee as the auditor proceeds to a more in-depth documentation of accounting cycles and the related systems of internal control. The auditor must accept that conditions are bound to change during the course of an audit and be flexible enough to handle departures from plans to address changing requirements.

As with all documentation, the ARA and the audit strategy/audit plan must meet the “experienced auditor” requirement. That is to say, an experienced individual with audit competence and skills must be able to follow and understand the proposed audit strategy.

### **DOCUMENT THE PLANNING PHASE: GANTT CHART THE AUDIT APPROACH**

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The drafting of a written audit plan is essential for compiling, consolidating, and then communicating the essentials of the planning phase to the audit team, and the audit plan should be required reading by each team member. However necessary and required (by auditing standards and Federal regulations), the written plan may have limitations. It is up to the audit directors and team managers to check that all important audit management considerations are described accurately and succinctly. Otherwise, review of the documentation will consume time and resources and may result in a less-than-optimal audit.

In addition to the written plan, audit management as well as the entire team will benefit from reviewing the answers to these questions based on their knowledge of audit-related facts:

- How the audit phases are integrated with prescribed audit procedures?
- What are the audit procedures and audit tasks that must be performed?
- What is the start date, duration, and end date for each audit procedure and task?
- Who is to perform each audit procedure and task?
- What are the critical path, the critical procedures, and the critical success factors of the audit?
- What procedures and tasks must be completed on time to keep from jeopardizing the audit completion date?
- When and what interim or periodic reporting is to be made to the Federal Agency?
- What reviews, how often, and when will audit management review the audit progress?
- What are the level and hours of staffing committed to performance of which audit procedures and related audit tasks?
- How are the individual members of the audit team to be scheduled to coordinate and execute the audit?

All of these are essential issues, but they are not easily illustrated, portrayed, or communicable to audit team members. A management tool widely used by industrial engineers and the major management consulting firms, and to a lesser degree by the audit profession, is charting, more specifically, the construction and use of Gantt charting. The Gantt chart (note that there are more than a few variations of the name of this technique) permits the graphic display of audit milestones, significant events, and procedures to be accomplished, along with approval and reporting points and audit completion dates. At the same time, a Gantt chart informs members of the audit team of who is to do what and when. The process requires audit management to approach the “Gantting” from two viewpoints:

1. Determine and schedule each audit procedure and audit task required to be completed. Begin at the starting point in the written audit plan and proceed to the completion of the last task of the audit: Deliver the audit report(s).
2. Determine and schedule the estimated time to complete each audit procedure and task. This time, however, begin with the end dates for (a) the audit, (b) each required audit procedure, and (c) each audit task and work backward, fixing the estimated completion times for each audit procedure and audit task.

As may be evident, the Gantting exercise has the potential for providing another advantage: the identification of gaps, duplications, omissions, and other issues within the audit plan and audit approach that may have to be reexamined before the full audit team arrives at the audit site.

# APPENDIX TO CHAPTER 8

## SPECIFIC CONTROL EVALUATION WORKSHEET

Internal Control Phase

395 H - Specific Control Evaluation Worksheet

ENTITY: <i>XYZ Agency (XYZ)</i> DATE OF FIN. STMTS: <i>9/30/xx</i> ACCOUNTING APPLICATION: <i>Cash Receipts</i>		SPECIFIC CONTROL EVALUATION FILE: _____			PREPARER _____ DATE _____ Page ___ of ___			
ACCOUNTING APPLICATION: CASH RECEIPTS								
ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVENESS OF CONTROL ACTIVITIES	DOC REF. & CONTROL TESTING STEP
	<i>Cash</i>	<i>Accts. Rec.</i>						
<i>Existence or occurrence</i>	<i>Existence or occurrence</i>	<i>Completeness</i>	<i>Occurrence/validity: 1. Receipt is recorded, but cash is not received.</i>	<i>Ia. Recorded cash receipts and cash receipt processing procedures are authorized by federal laws, regulations, and management's policy.</i>  <i>Ib. Appropriate individuals approve recorded receipts in accordance with management's general or specific criteria.</i>  <i>Ic. Recorded receipts represent amounts actually received by the entity and are properly classified.</i>	<i>Ia. Receipts processing is governed by documented procedures for accepting, obtaining, reviewing, and approving receipts.</i>  <i>Ib. A supervisor reviews receipts processing to provide reasonable assurance that procedures are followed.</i>  <i>Ic. Recorded cash receipts are matched with the appropriate supporting documentation.</i>  <i>Ic. Entries to the accounting records are reviewed and approved by supervisory personnel.</i>	<i>N</i>  <i>N</i>  <i>N</i>  <i>N</i>	<i>Effective</i>  <i>Effective</i>  <i>Effective</i>  <i>Effective</i>	<i>[In this column, the auditor would indicate, by cross-referencing, the audit procedures in the detailed control testing audit plan that were designed to test each effective control determined to be relevant. Such tests will involve inquiry, observation, inspection, or a combination thereof.]</i>

Internal Control Phase

395 H - Specific Control Evaluation Worksheet

ACCOUNTING APPLICATION ASSERTION		RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVENESS OF CONTROL ACTIVITIES	DOC REF. & CONTROL TESTING STEP
		Cash	Accts. Rec.						
				<p><i>Cutoff:</i></p> <p>2. Receipts are recorded in this period, but the cash is received in a different period.</p> <p><i>Summarization:</i></p> <p>3. Receipt transactions are overstated due to improper summarization.</p>	<p>2. Cash receipts recorded in the period are actually received in the period.</p> <p>3. The summarization of receipt transactions is not overstated.</p>	<p>2. Recorded receipts are reconciled to cash receipts listings and bank deposit reports before posting.</p> <p>3a. Receipt data in the general ledger are reconciled to subsidiary cash ledgers and records.</p> <p>3b. Batch totals of input documents are reconciled to output registers, journals, reports, or file updates.</p>	<p>Y</p> <p>Y</p> <p>Y</p>	<p>Effective</p> <p>Effective</p> <p>Effective</p>	
Completeness	Completeness	Existence or occurrence		<p><i>Transaction completeness:</i></p> <p>4. Cash is received, but receipt is not recorded.</p>	<p>4. All receipts of cash are recorded and properly classified.</p>	<p>4a. Cash receipts are listed by the central mailroom staff and independently reconciled to deposits and accounting summaries, providing adequate</p>	N	Effective	

Internal Control Phase

395 H - Specific Control Evaluation Worksheet

ENTITY: <u>XYZ Agency (XYZ)</u>		SPECIFIC CONTROL EVALUATION			PREPARER _____			
DATE OF FIN. STMTS: <u>9/30/xx</u>		FILE: _____			DATE _____ Page ___ of _____			
ACCOUNTING APPLICATION: <u>Cash Receipts</u>								
ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u>								
ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVENESS OF CONTROL ACTIVITIES	DOC REF. & CONTROL TESTING STEP
	Cash	Accts. Rec.						
			<p><i>Cutoff:</i></p> <p>5. <i>Cash is received in this period, but receipt is recorded in a different period.</i></p> <p><i>Summarization:</i></p> <p>6. <i>Receipt transactions are understated as a result of improper summarization.</i></p>	<p>5. <i>Cash receipts actually received in the period are recorded in the period.</i></p> <p>6. <i>The summarization of cash receipt transactions are not understated.</i></p>	<p><i>segregation of duties. Collections and complaints are handled by others.</i></p> <p>4b. <i>Supervisory reviews of the processing of cash receipts.</i></p> <p>5. <i>Same as procedure 2 above.</i></p> <p>6. <i>Same as procedure 3a and 3b above.</i></p>	<p>N</p> <p>Y</p> <p>Y</p>	<p><i>Effective</i></p> <p><i>Effective</i></p> <p><i>Effective</i></p>	



Internal Control Phase

395 H - Specific Control Evaluation Worksheet

ENTITY: <u>XYZ Agency (XYZ)</u> DATE OF FIN. STMTS: <u>9/30/xx</u> ACCOUNTING APPLICATION: <u>Cash Receipts</u>			SPECIFIC CONTROL EVALUATION FILE: _____			PREPARER _____ DATE _____ Page ____ of _____		
ACCOUNTING APPLICATION: <u>CASH RECEIPTS</u>								
ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVENESS OF CONTROL ACTIVITIES	DOC REF. & CONTROL TESTING STEP
	Cash	Accts. Rec.						
<i>Accuracy/valuation</i>	<i>Valuation</i>	<i>Valuation</i>	<i>Accuracy: 7. Receipt transactions are recorded at incorrect amounts.</i>	<i>7. Receipt transactions are recorded accurately.</i>	<i>7a. Recorded receipts are compared with bank statements by persons who have no other receipts processing responsibilities.  7b. Supervisor reviews and approves reconciliations of recorded receipts to bank statements.</i>	<i>Y</i>	<i>Effective</i>	
<i>Segregation of duties</i>	<i>Various</i>	<i>Various</i>	<i>Segregation of Duties: 8. The entity is exposed to loss of cash receipts and various misstatements as the result of inadequate segregation of duties.</i>	<i>8. Persons are prevented from having uncontrolled access to both cash receipts and records.</i>	<i>8a. No individual has uncontrolled access (direct or indirect) to both cash receipts and records.</i>	<i>N</i>	<i>Effective</i>	
Preparation Notes: <ol style="list-style-type: none"> <li>1. The third column is for use when the effects of the accounting application on the line items are different. For example, misstatements in the existence or occurrence assertion for cash receipts typically result in misstatements in the existence or occurrence assertion for cash and in the completeness assertion for accounts receivable (see FAM 330.05).</li> <li>2. If there is inadequate segregation of duties, the auditor should identify the specific affected account assertions in columns 2 and 3.</li> </ol>								

**ACCOUNT RISK ANALYSIS FORM**

Internal Control Phase

395 I - Account Risk Analysis Form

ENTITY: <u>XYZ Agency (XYZ)</u>		ACCOUNT RISK ANALYSIS FORM				PREPARER _____				
DATE OF FINANCIAL STATEMENTS: <u>9/30/xx</u>		FILE: _____				DATE _____ Page ____ of _____				
LINE ITEM: <u>Accounts Receivable - Net</u>										
PLANNING PHASE				INTERNAL CONTROL PHASE			TESTING PHASE			
Account		Financial Statement Assertions	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective ness of Control Activities	Control Risk	Risk of Material Mistatement	Timing I/F	Nature & Extent	Doc. Ref. & Audit Step
Name	Balance									
<i>Accounts Receivable-Net</i>	<i>\$876,000,000</i>	<b>Existence or occurrence</b>	<i>No significant inherent, fraud, or control risk factors identified.</i>	<i>Sales/ Billing</i>	<i>Effective</i>	<i>Low</i>	<i>Low</i>	<i>F</i>	<i>Confirm balances and test reconciliation of subsidiary ledger to the general ledger.</i>	<i>III-5 to III-7</i>
				<i>Sales Returns</i>	<i>Effective</i>					
				<i>Cash Receipts</i>	<i>Effective</i>					
				<i>Accounts Receivable</i>	<i>Effective</i>					
		<b>Completeness</b>	<i>No significant inherent, fraud, or control risk factors identified</i>	<i>Sales/ Billing</i>	<i>Effective</i>	<i>Low</i>	<i>Low</i>	<i>F</i>	<i>Perform analytical procedures. Test cutoff.</i>	<i>III-8 to III-12</i>
				<i>Sales Returns</i>	<i>Effective</i>					
				<i>Cash Receipts</i>	<i>Effective</i>					
				<i>Accounts Receivable</i>	<i>Effective</i>					

Internal Control Phase

395 I - Account Risk Analysis Form

Account		PLANNING PHASE			INTERNAL CONTROL PHASE			TESTING PHASE		
Name	Balance	Financial Statement Assertions	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective ness of Control Activities	Control Risk	Risk of Material Mista- ment	Timing I/F	Nature & Extent	Doc. Ref. & Audit Step
		<b>Accuracy/ valuation</b>	<i>The bankruptcy filing by a major debtor and the financial difficulties of several other debtors in the current economic environment give rise to an inherent risk. No significant fraud or control risk factors identified.</i>	<i>Sales/ Billing Sales Return Cash Receipts Accounts Receivable</i>	<i>Effective Effective Effective Effective</i>	<i>Low</i>	<i>Moderate</i>	<i>F</i>	<i>Confirm balances (see Existence), test the accuracy of the aging, analytically review bad debts and allowance, and examine evidence of collectibility for selected accounts receivable. Discuss with management collectibility from troubled debtors.</i>	<i>III-13 to III-18</i>

Internal Control Phase

395 I - Account Risk Analysis Form

Account		PLANNING PHASE			INTERNAL CONTROL PHASE			TESTING PHASE		
Name	Balance	Financial Statement Assertions	Inherent, Fraud, and Control Risk Factors	Cycle/Accounting Application	Effectiveness of Control Activities	Control Risk	Risk of Material Misstatement	Timing I/F	Nature & Extent	Doc. Ref. & Audit Step
		<b>Rights and Obligations</b>	No significant inherent, fraud, or control risk factors identified.	Accounts Receivable	Effective	Low	Low	F	Identify accounts receivable from related parties or major debtors. Review confirmations for indication of guarantees or encumbrances.	III-19 to III-22
		<b>Presentation and Disclosure</b>	No significant inherent, fraud, or control risk factors identified.	Accounts Receivable	Effective	Low	Low	F	Determine appropriateness of footnote disclosures using FAM 2010 and FAM 2020 checklists. Summarize and test credit risk disclosures. Review accounting principles used.	III-23 to III-25, IV-16
<i>Line Item Total</i>	\$876,000,000									

# 9 DOCUMENTING INTERNAL CONTROLS

## ***What, Who, Where, and Why?***

At the outset of an audit, the auditor must have a clear idea of the audit scope to identify a process that will achieve the audit objectives. Chapter 7 provided a summary of the Federal audit model jointly developed by the U.S. Government Accountability Office (GAO), the President’s Council on Integrity and Efficiency (PCIE), and the Office of Management and Budget (OMB). Exhibit 7.1, Federal Audit Model—Agency Financial Statements depicts in a graphic format the audit phases, procedures, and tasks that are described in some 1,000+ pages of Federal guidance appearing in the *Financial Audit Manual (FAM)*, the *Federal Information Security Controls Audit Manual (FISCAM)*, and the *Standards for Internal Controls in the Federal Government*. According to the Federal audit model introduced in Chapter 7 and as discussed in greater detail in Chapter 8, the auditor’s effort to understand controls is initiated during the planning phase of the audit and continues to be reexamined, refined, and revised during the entire internal control phase.

The second auditing standard of fieldwork states in part: “The auditor must obtain a sufficient understanding of the entity . . . including internal controls to assess the risk of material misstatement of the financial statements.” This chapter addresses internal control documentation, internal control definitions and requirements, and selected evaluation aspects of internal controls. Exhibit 9.1 is a graphic depiction of audit procedures and tasks designed to document and fully assess the impact (both positive and negative) of existing controls on a Federal Agency’s financial statements. The objective of this chapter is to underscore the proper priority that must be given to this phase of the Federal audit model, as required by Federal law, regulations, and auditing standards.

### **INTERNAL CONTROLS, DEFINITIONS, AND REQUIREMENTS**

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The most authoritative AICPA source on internal controls is U.S. Auditing Standards—AICPA (Clarified) (AU-C) 315 which is based on a Committee of Sponsoring Organizations (COSO) report. AICPA defines internal control as

a process—effected by those charged with governance about the achievement of the entity’s objectives with regard to the reliability of financial reporting, effectiveness, and efficiency of operations and compliance with applicable laws and regulations.

**A. Views of Internal Controls**

**The AICPA: Internal Controls**

**Audit and Attestation Standards:**

- AU-C 315
- AU-C 330
- AU-C 402
- AU-C 265
- SSAE 15
- SSAE 16

**AICPA GAAS Audit Standards:**

- Understand controls to determine timing, nature, and extent of testing
- Not an audit of controls
- No external report on controls

**Federal Government: Internal Controls**

**Federal Laws:**

- FMFIA of 1982
- CFO Act of 1990
- GPRA Act of 1993
- FFMA of 1996
- FISMA of 2002
- Sarbanes-Oxley Act of 2002

**GAO:**

- Government Auditing Standards
- Financial Audit Manual
- Federal Information System Controls Audit Manual
- Standards for Internal Control in the Federal Government
- Against loss from unauthorized acquisition, use, or disposition

**OMB Regulations:**

- OMB Bulletin 07-04
- OMB Circular A-123
- OMB Circular A-127
- OMB Circular A-130

**Sarbanes-Oxley Act: Internal Controls**

**Management will:**

- Assess and report on the effectiveness of controls

**Independent CPAs will:**

- Audit and report on the effectiveness of internal controls

- Audit and report on financial statements

**B. Confirm Understanding of Controls Systems**

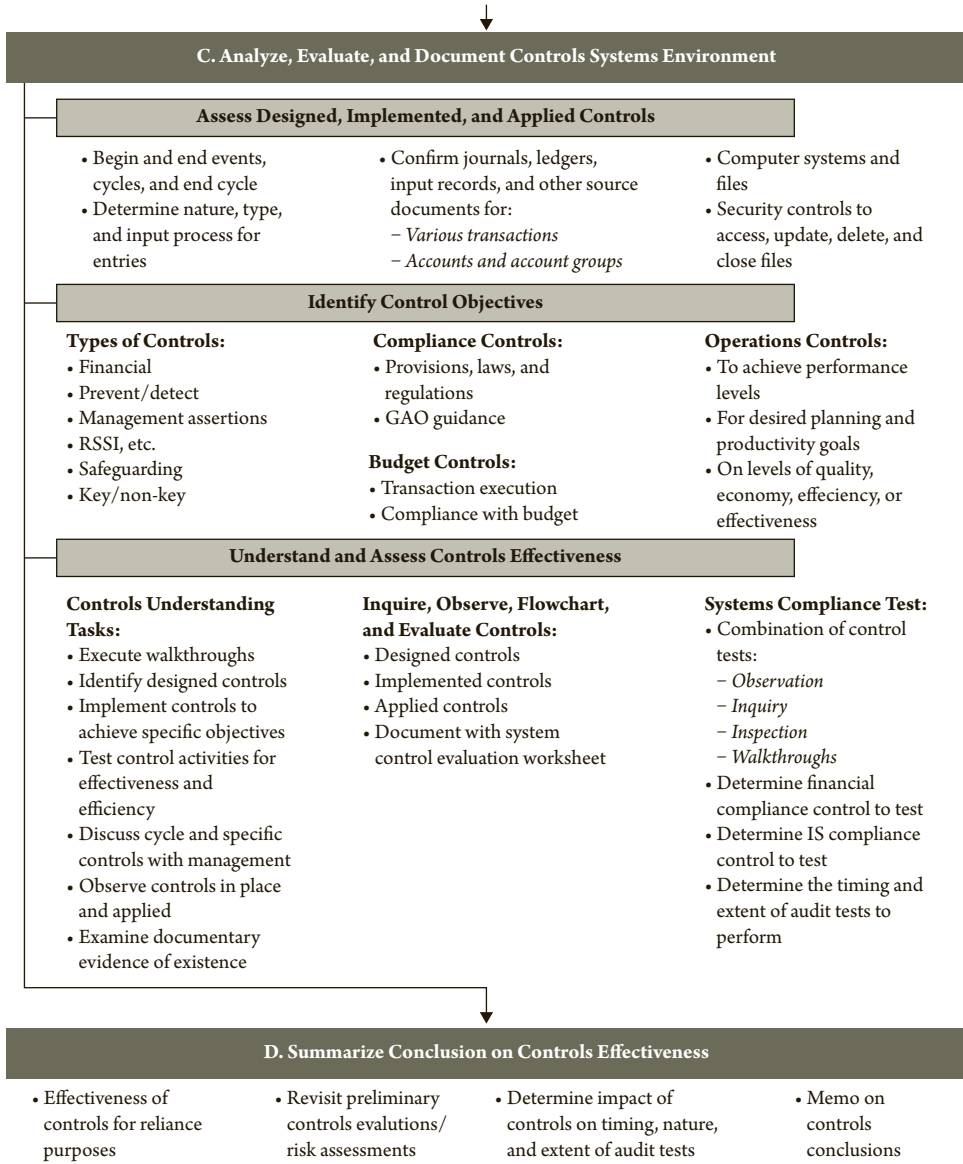
**Examine Documentation**

- Controls documentation:
  - External to agency
  - Internal to agency
- Inquire and observe systems
- Inspect documentation
- Observe event cycle
- Flow controls and system flow charts

**Review by Transactions and Applications**

- Use controls, questionnaires, and checklists
- Perform controls and systems walkthroughs/test of designs
- Trace applications for:
  - Payroll and benefits
  - Travel and transportation
  - Contracts and procurement
  - Grants
  - Supplies and materials
  - Utilities
  - Inter-Federal Agencies
- Review flowcharting
- Prepare controls memos
- Document/Chart Major Systems:
  - Accounting systems
  - Information systems
  - Budgetary systems
  - Compliance with laws and regulations
  - Relevant operational systems
  - Performance systems

**EXHIBIT 9.1 Internal Control Phase of the Audit**



**EXHIBIT 9.1 Continued**

The definition goes on to incorporate COSO’s internal control components (control environment, entity’s risk assessment, information and communication systems, control activities, and monitoring).

It is important to note that although the AICPA adopted the broader definition of internal controls, as a general rule (and depending on the audit scope itself), the auditor is

not required to consider efficiency of operations and compliance with laws and regulations in connection with an audit conducted pursuant to the AICPA's generally accepted auditing standards (GAAS).

Although Congress and OMB incorporate COSO's definition, they both define the internal control structure for government purposes in broader terms. OMB's introduction to Circular A-123, *Management Responsibility for Internal Control*, states:

The FMFIA [Federal Managers' Financial Integrity Act] establishes overall requirements with regard to internal control. The agency head must establish controls that reasonably ensure that: "(i) obligations and costs are in compliance with applicable law; (ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets." In addition, the agency head annually must evaluate and report on the control and financial systems that protect the integrity of Federal programs (Section 2 and Section 4 of FMFIA, respectively). The three objectives of internal control are to ensure the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

## INTERNAL CONTROLS, A HISTORICAL PERSPECTIVE

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Over the years, increasing attention and concern has been directed by Congress in its laws and Federal Agencies in their regulations toward the importance of the auditee's internal control structure. Within the Federal Government, many executives support the premise that audits of controls are quite possibly, from a management and oversight perspective, as important as the detailed auditing of financial information itself. These views have been volunteered and endorsed by members of the accounting profession, independent commissions, Congress, as well as Comptrollers General of the United States.

Even prior to the implementation of the Sarbanes-Oxley Act (SOX) in 2002, an auditor's scope for assessing and reporting on internal controls was greater for audits of governmental entities than for audits of corporate financial statements. Governmental auditing standards have traditionally required the auditor to issue reports on internal controls. In the past, AICPA standards required only that *reportable conditions* (which may also be referred to as *significant deficiencies*) and material weaknesses be brought to the attention of the audit committee or other appropriate executive/management level of the auditee. With the issuance of Statements on Auditing Standards (SASs) 112, *Communicating Internal Control Related Matters Identified in an Audit*, and 114, *The Auditor's Communication with Those Charged with Governance*, the standards now make it clear that



the auditor must communicate in writing significant deficiencies and material weaknesses to management and individuals charged with governance. As noted in an earlier chapter, commercial audit standards have never been closer to *Government Auditing Standards*. In fact, as noted later, in some respects the commercial guidance on internal controls is even more demanding than the equivalent Federal guidance.

The catalyst for these changes can be traced directly to the Enron scandal that was revealed in October 2001 as well as other corporate financial wrongdoings that marred the beginning of the millennium. These scandals precipitated the issuance of the SOX in 2002, which created the Public Company Accounting Oversight Board (PCAOB) and changed internal control requirements (at least for publicly traded companies and companies opting to comply with PCAOB standards). The Federal Government's reaction to the scandals and wrongdoings described above, in turn hastened the passage of 13 new "2006 standards," which were discussed in Chapter 6.

It would be unfair to leave the reader with the impression that the AICPA and the accounting profession had ignored internal controls until they were forced to act due to these unfortunate events. In this regard, these initiatives merit consideration:

- In April 1988, the AICPA issued ten SASs, referred to as the "expectation" SASs, with at least four of these SASs outlining new auditor responsibilities or defining with more specificity the auditor's responsibility for internal controls and for communicating the results of tests of controls under certain adverse conditions.
- COSO of the Treadway Commission developed an expanded definition of internal controls emphasizing that increased importance be given to controls. The 1992 COSO report identified five prerequisites of an effective internal control structure to include:
  - a. The control environment.
  - b. Risk assessment.
  - c. Control activities.
  - d. Information and communications.
  - e. Monitoring.
- GAO reported on a survey of major bank audit committees, asking what they desired from an audit and what they felt was lacking. The survey revealed that audit committee members desired more reporting on internal controls and that compliance with existing laws and regulations governing reporting on the financial statement audit, and internal controls was not meeting the needs of audit committee members.
- A shift in the historic audit paradigm was proposed by GAO in 1993 when the Comptroller General recommended that changes in auditing standards give increased audit coverage to controls. This broader draft audit standard supported GAO's thesis that audits of internal controls were as important, if not more so,

than the auditing and reporting on historical information only. GAO believed that auditing standards should explicitly and implicitly elevate the audit work on internal controls to the level afforded to substantiating data in financial statements.

- The desired changes would affect several areas:
  - a. The scope of the controls reviewed should be expanded beyond the internal accounting and administrative controls now envisioned by GAAS.
  - b. The objective of auditing controls should be elevated to a level of emphasis commensurate with the audit of financial data.
  - c. There should be a separate reporting (i.e., a separate opinion on the effectiveness of controls) by the auditor.

The second half of the 1990s and the years preceding the passage of SOX in July 2002 produced a significant number of pronouncements by the AICPA affecting internal controls. Notable examples include:

- SAS 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*
- SAS 82, *Consideration of Fraud in a Financial Statement Audit* (superseded in October 2002 by SAS 99 bearing the same title)
- SAS 88, *Service Organizations and Reporting on Consistency* (which amended SAS 70, *Service Organizations*)
- SAS 90, *Audit Committee Communications*
- SAS 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*
- Statement on Standards for Attestation Engagements (SSAE) 10, *Attestation Standards: Revision and Recodification* (which amended SSAE 6, *Reporting on an Entity's Internal Control over Financial reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2*)

In short, the concept of increasing the audit attention given to internal controls has been gaining momentum for years. The passage of SOX and the creation of PCAOB by requiring auditors' opinions on internal controls and the related management assertion have resulted in the internal control requirements of one area of the private sector, publicly traded companies, exceeding the requirements imposed on Federal Agencies.

## FEDERAL STANDARD SETTERS

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The need for strong, effective internal controls cannot be overemphasized. Because of the fiduciary nature of governmental operations and the scrutiny the Federal Government is subjected to by taxpayers, governmental bodies, and agencies involved with the

development of internal control guidance, this guidance does not always consist of “suggestions” for best practices. Indeed, substantial noncompliance with certain Federal guidance, such as that of the OMB, constitutes an event of noncompliance with laws and regulations, and noncompliance is an illegal reportable event. Even more specifically, the Federal Financial Management Improvement Act (FFMIA) requires the auditor to test compliance with Federal requirements over financial management systems, to apply Federal accounting standards, and to implement these standards in its standard general ledger at the transaction level. If the agency does not “substantially” comply with these requirements, noncompliance is to be disclosed in the auditor’s report.

Besides laws of Congress, there are a number of other authoritative Federal regulations and guidance on assurances required of internal control and related reporting requirements, such as:

- *Office of Management and Budget*. OMB provides guidance on the implementation of, and compliance with, congressional legislation affecting internal controls. Guidance is typically issued in the form of OMB circulars, although internal control–related guidance can also be found in OMB bulletins.
- *Government Accountability Office (formerly General Accounting Office)*. GAO is required by law (the FMFIA of 1982) to develop the internal control standards that apply to the Federal Government, which it has done and which have been implemented and are being applied by Federal Agencies.

In addition, these agencies also have a direct impact on Federal internal controls:

- *Department of the Treasury*. Through its *Treasury Financial Manual* and other guidance, the Treasury Department is responsible for defining the fiscal responsibilities of Federal Agencies by providing internal control–related policies, procedures, and instructions. In addition, the department’s Financial Management Services (FMS) is responsible for the consolidation of the annual financial statements of the Federal Government. As such, FMS is responsible for developing the controls and procedures governing the financial statement consolidation process.
- *Office of Personnel Management (OPM)*. Through the issuance of policies affecting all aspects of human resources within the Federal Government, OPM is responsible for issuing controls that affect the most important resource in the Federal Government—its human capital.

Arguably, these four central Federal Agencies have had the greatest impact on internal controls. These agencies comprise the principals of the Joint Financial Management Improvement Program (JFMIP). To this end, in 2004 JFMIP issued its *Framework for Federal Financial Management Systems* as well as requirements documentation covering a variety of Federal financial systems.

In December 2004, the principals of JFMIP voted to realign the program, and JFMIP's functions were taken over by the Federal Systems Integration Office (FSIO). On March 31, 2010, OMB determined that FSIO had completed its mission, and the office was terminated. The JFMIP framework, however, is still an important reference for determining basic system requirements in the Federal Government.

Other organizations that deserve mention when identifying the developers of Federal internal controls and audit-related policy and guidance are listed next.

- *Chief Financial Officers Council (CFOC)*. This council consists of the chief financial officers (CFOs) and deputy CFOs of the largest Federal Agencies as well as senior managers from OMB and the Department of Treasury. The council was created by the CFO Act of 1990 and charged with the task of improving Federal financial management. In addition, the CFOC was responsible for coordinating the activities of Federal Agencies in connection with financial practices, including systems and internal controls.
- *Council of the Inspectors General on Integrity and Efficiency (CIGIE)*. CIGIE is the successor to the President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE). The council was established by the Inspector General Reform Act of 2008 to:
  - Address integrity, economy, and effectiveness issues that transcend individual government agencies; and
  - Increase the professionalism and effectiveness of personnel by developing policies, standards, and approaches to aid in the establishment of a well-trained and highly skilled workforce in the offices of the Inspectors General (IGs).

Among other objectives, CIGIE is concerned with Federal auditing issues, including audit effectiveness, audit training, prevention of waste fraud and abuse, and the overall effectiveness of government programs.

- *Chief Information Officers Council (CIOC)*. This council was established by executive order in 1996 to promote the efficient and effective utilization of Federal information resources. Although its emphasis is usually on modernization and the effective application of advanced information technology, the council is involved with significant Federal systems security and internal control issues.
- *Federal Accounting Standards Advisory Board (FASAB)*. FASAB is primarily responsible for developing accounting principles, not internal controls, for the Federal Government. Even though some readers may not agree that FASAB should be mentioned in connection with internal controls, the first document issued by FASAB, *Statement of Federal Financial Accounting Concepts 1 (SFFAC 1)*, *Objectives of Federal Financial Reporting*, identified four major reporting objectives: (1) budgetary integrity, (2) operating performance, (3) stewardship, and (4) systems and control. Two of these objectives, budgetary integrity and

systems and control, address internal controls that promote compliance with laws and regulations, safeguarding of assets, and fairness of presentation. All of these financial reporting objectives are integral to any audit made of a Federal Agency's financial statements.

While it is clear that FASAB's role is not as broad as those of OMB or GAO with regard to internal controls, it is also undeniable that FASAB has played a role in the development of standards promoting internal controls within the Federal Government.

In addition to the organizations mentioned, many other organizations are involved in the development of internal control guidance for the Federal Government. Virtually all cabinet-level agencies (and many of their departmental components) have developed their own internal control guidance addressing the unique requirements of each agency. In practical terms, the auditor will look to OMB and GAO for guidance on internal controls; however, the auditor must be aware of other organizations that play significant roles. Finally, it is crucial for the auditor to recognize that the existence of so many concerned organizations highlights the importance internal controls are afforded in the Federal Government arena.

This section has addressed guidance developed by the Federal Government and Federal Agencies. Internal control guidance can, of course, be found in sources outside of the Federal Government or from those sources that are not directly responsible for issuing Federal-related internal control guidance. One such source is the *Internal Control—Integrated Framework* developed by COSO of the Treadway Commission. The *COSO Framework* contains an extremely comprehensive discussion of internal controls and has been adopted by GAO in its *Standards for Internal Control in the Federal Government* (Green Book). The *COSO Framework* is currently being revised, and a discussion paper has been issued. The reader is advised to follow the progress of any potential changes to the *COSO Framework* as these changes will very likely be adopted by Federal standard setters.

## **SELECTED FEDERAL GUIDANCE**

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### **Laws of Congress**

The most authoritative internal control guidance in the Federal Government is the body of laws and regulations passed by Congress. Each law is supplemented by provisions in OMB pronouncements (typically in the form of OMB circulars), which serve as the regulatory implementation guidance that Federal executive agencies must follow. This section provides an overview of some of the most significant laws, regulations, and OMB guidance affecting internal controls as well as other selected guidance. Laws and guidance over Federal financial management, accounting, and auditing are constantly changing. Auditors must be cognizant of the imminence of change at all times and follow the development and/or enactment of any new Federal financial guidance.

Congress has been involved in the promotion of competent financial management and sound internal controls virtually since the creation of the Republic. Today, some of the more significant legislative actions have included:

- *Inspector General Act of 1978 (IG Act)*. This act was a major congressional initiative to create independent and objective units within departments and agencies to conduct and supervise audits and investigations and promote internal controls to ensure operating efficiency and effectiveness and prevent and/or detect fraud.
- *Federal Managers' Financial Integrity Act of 1982*. FMFIA was, and arguably still is, the most significant congressional legislation addressing the existence and effectiveness of systems of internal controls. FMFIA amended the Accounting and Auditing Act of 1950 and makes it clear that effective controls (both accounting and administrative) are essential. The act identifies general criteria that must be adhered to in the design and maintenance of accounting systems in compliance with the standards for internal controls to be developed by the Comptroller General. In addition, the act assigned to OMB (in consultation with GAO) the responsibility of developing guidelines for implementation of the FMFIA legislation (see the OMB Circular A-123 discussion later in this section). An important feature of FMFIA is the requirement that the heads of each executive branch agency issue annual reports to the President and Congress on whether the agency's internal controls comply with Federal standards.
- *Chief Financial Officers Act and Government Management and Reform Act (GMRA)*. The CFO Act of 1990 provides for the production of audited financial statements and addresses the need for strengthened financial management leadership, long-range planning, and improved financial reporting. Regarding internal controls, the CFO Act requires audits to comply with *Government Auditing Standards* and, as such, include reports on the results of mandated tests of internal controls and compliance with laws and regulations. The scope of the CFO Act was later expanded by the GMRA in 1994, which significantly increased the number of Federal Agencies subject to annual audits.
- *Government Performance and Results Act (GPR)*. GPR requires the development of a long-range strategic plan addressing performance, including the identification of specific goals and objectives. Actual performance is to be reported and compared to the plan. GPR reporting is, by itself, a significant administrative control that forces Federal Agencies to focus on performance. Internal controls are also important to the achievement of GPR objectives, and OMB requires that controls promoting the fair presentation of performance be reviewed by the agency's auditors (although there is currently no requirement to express an opinion on the effectiveness of controls).
- *Clinger-Cohen Act*. Also known as the Information Technology Management Reform Act (ITMRA), the Clinger-Cohen Act promotes information technology

- (IT) compliance with GPRA by promoting, among other objectives, effective management and controls over the IT acquisition process and ensuring that IT planning and investing are tied directly to the Federal Agency's mission and goals.
- *Federal Financial Management Improvement Act of 1996*. FFMIA establishes certain financial management system requirements to be followed by Federal Agencies. It also requires an auditor to report on compliance with laws and regulations and state whether an agency's financial management systems comply with:
    - Federal financial management systems requirements.
    - Applicable Federal accounting standards.
    - U.S. government standard general ledger, at the transaction level.
  - *Federal Information Security Management Act (FISMA)*. FISMA was passed into law in 2002, replacing the Government Information Security Reform Act of 2000 (GISRA). FISMA requires the development of minimum standards for agency systems and dictates that Federal Agencies conduct annual IT security reviews and have IGs perform annual independent evaluations of agency programs and systems. The results of these reviews and evaluations are to be reported annually to OMB and Congress. FISMA also includes provisions aimed at further strengthening the security of the Federal Government's information and information systems. FISMA provides additional guidance regarding configuration management, continuity of operations, and maintenance of an inventory of major information systems that provides for the identification of the interfaces between all systems.

### **Office of Management and Budget**

OMB is responsible for the development of instructions and guidance to assist Federal Agencies in their efforts to comply with congressional legislation. OMB guidance is issued in the form of circulars, bulletins, and memoranda.

Regarding internal controls, the most significant controls guidance available to Federal Agencies is contained in OMB Circular A-123, *Management Responsibility for Internal Control*. OMB Circular A-123 implements FMFIA, and compliance is required of all executive branch agencies. The circular is updated periodically to reflect evolving views and techniques relating to internal controls and to promote government effectiveness and efficiency. The circular and its appendices consist of these parts:

- Appendix A, Implementation Plans (2005)
- Appendix A, Implementation Guide (2005)
- Appendix A, Frequently Asked Questions (2006)
- Appendix B, Government Charge Card Programs(2009)
- Appendix C, Requirements for Effective Measurement and Remediation of Improper Payments

- Parts I and II (2011)
- Parts III (2010)
- Conducting Acquisition Assessments under OMB Circular A-123 (2008)

The purpose of the revised circular, as set forth in the document dated December 21, 2004, is to provide guidance to Federal managers addressing:

- Management's responsibility for internal control.
- The process for assessing internal control effectiveness and new requirements for conducting the assessment.
- Updated internal control standards.
- The integration and coordination of internal control assessments.

Other circulars and bulletins with significant internal control implications include:

- OMB Circular A-127, *Financial Management Systems*. This circular prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems.
- OMB Circular A-129, *Managing Federal Credit Programs*. This circular prescribes policies and procedures in connection with the accounting, management, and control of Federal credit programs. It also provides guidance to comply with the Federal Credit Reform Act and financial system standards designed to properly account for and control Federal credit programs. With loans, loan guarantees, and other financial transactions, such as certain long-term leases, being subject to credit reform, virtually every Federal Agency must comply with the accounting and control requirements of the act and Circular A-129.
- OMB Circular A-130, *Management of Federal Information Resources*. This circular prescribes policy for the management of Federal information resources, including specific implementation guidelines. The circular was issued pursuant to several laws including the ITMRA and the CFO Act. It addresses several control issues, including security and controls over IT investments.
- OMB Bulletin 07-04 (as revised in 2008), *Audit Requirements for Federal Financial Statements*. This bulletin is primarily designed to provide audit-related guidance to Federal Agencies and the auditors of Federal Agencies. However, it also includes internal control guidance and definitions for significant deficiencies and material weaknesses.
- OMB Memoranda and Reports. OMB routinely issues memoranda and reports with internal control requirements and implications. These memoranda and reports may impact the audit of Federal Agencies.

### **Government Accountability Office**

Although GAO is usually associated with Federal investigations and Federal auditing, including the development of *Government Auditing Standards* (Yellow Book), GAO is also a



primary source of guidance concerning internal controls and related best practices. The most influential sources of GAO internal control guidance are listed next.

- *Standards for Internal Control in the Federal Government* (1999). The Green Book was developed by GAO as mandated by Congress in the passage of the FMFIA. In the act, Congress required GAO to issue standards for internal control in government. The document, which closely parallels the *COSO Framework* standards, provides a general financial internal controls framework and considers controls related to computer technology. As stated by GAO, the purpose of its *Standards for Internal Control* is to assist in establishing and maintaining internal controls in the Federal Government and to enable agency managers to identify and address “major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement.”
- *GAO/PCIE Financial Audit Manual*. GAO’s *FAM* is clearly designed to assist the Federal auditor in the execution of his or her audit procedures and not as a statement of sound internal controls. However, the nature of *FAM*, particularly Sections 200, “Planning,” and 300, “Internal Control,” is such that the manual, by guiding the auditor in what to do and look for, serves as a very helpful source of best practices in internal controls.
- *Federal Information System Controls Audit Manual*. Like *FAM*, *FISCAM* is designed to assist in the audit of Federal Agencies and is not meant as a briefing on internal controls. However, by discussing control objectives and providing relevant examples of the control techniques followed by Federal Agencies, *FISCAM*, like *FAM*, is an invaluable source of best practices in internal controls.

Prior to the initiation of any audit, it is essential that an auditor be aware of relevant requirements in order to properly define the audit scope and plan an audit in accordance with GAO standards and all other requirements (including agency-specific requirements, which are not covered in this chapter).

Fortunately, OMB, GAO, and most Federal Agencies are very efficient in disseminating requirements information. In addition, agency Web sites are usually current. Auditors are advised to consult these Web sites prior to initiating an audit.

## **INTERNAL CONTROL EVALUATION REQUIREMENTS**

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The AICPA’s adoption of the *COSO Framework* was documented in SAS 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*, an amendment to SAS 55, *Consideration of Internal Control in a Financial Statement Audit*. In turn, these SASs were superseded by SAS 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and SAS 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence*

*Obtained* currently AU-C 330. SAS 109 currently AU-C 315 contains guidance surrounding the auditor's evaluation of internal controls and assessment of the risk of material misstatements in the financial statements. The determination and execution of audit procedures pursuant to the auditor's risk assessment is contained in AU-C 330. The effects of AU-C 330 and AU-C 315 on the auditor's procedures are discussed further in subsequent chapters. In general, AU 314 guidance is provided to assist the auditor in:

- Identifying potential sources of information to support the development of an understanding of the entity.
- Developing an understanding the entity's internal control environment and specific internal controls.
- Developing a risk assessment, taking into consideration:
  - Potential risk events, including accounts and transactions that could be affected by each identified risk and mitigating internal controls that prevent or diminish the probability of occurrence.
  - Impact of the risk at the assertion level.
  - Potential significance/materiality of the risk and probability of occurrence.
- Documenting the system of internal controls and procedures performed.

In addition to the guidance just summarized, AU-C 315 uses the COSO model to define five controls relevant to ensuring the fair presentation of financial statements. These controls and a brief description are presented next.

1. *Internal control environment.* This term refers to the overall tone at the top, established and confirmed daily to agency personnel by management's actions and demonstrated concerns for effective controls.
2. *Risk assessment.* Assessments or evaluations of controls identify potential risks to the organization and lead to the direct development of policies and procedures to mitigate/negate this control risk. *Note: This ongoing assessment is an agency's responsibility. This distinction is important to avoid a misunderstanding between management's assessment of controls and the risk assessment and the control evaluation and testing required of the auditor in the performance of a financial audit pursuant to Federal audit guidance.*
3. *Information and communication practices.* These practices include the accounting and information systems, plus related procedures, manuals, books, and underlying records, as well as management's communications and promotion of internal controls policies and publication and enforcement of employee responsibilities for observing and assessing procedures and rules for the implemented controls.
4. *Control activities.* These are the actual control practices and procedures that are in place and used to execute management's control policies. This control component includes obvious control activities, such as transaction authorizations and

- approvals, processing of financial data, and segregation of duties, as well as less obvious activities, such as personnel reviews and training of the agency personnel.
5. *Monitoring*. This control component is directed toward how management promotes/enforces compliance with its control policies, including oversight functions. Although emphasis is typically placed on an agency's Office of Inspector General and/or internal auditor, plus the independent audit function, this does not need to be the extent of management's monitoring. Other evaluations by agency teams and external consultants and ongoing assessments by agency program management are equally valid indicators of the effectiveness of controls monitoring.

The auditor must develop an understanding of these basic components of an effective internal controls structure. Once this understanding is achieved, the auditor must determine whether these controls actually have been placed into operation and that they are being followed on a day-to-day basis. Most often this determination is made through auditor inquiries of agency management and operating personnel, personal observations by the audit team, and walk-throughs of offices and agency activity locations to personally witness controls in operation.

Once the auditor understands the internal controls and whether the controls have been in place throughout the year, he or she can proceed to evaluate internal controls and test and assess the practices employed in the operations of the accounting and financial management systems. Note that the auditor assessment is only preliminary and may have to be modified by the testing results.

Once again, it is important to note that a control that is usually associated with best practices is totally worthless to the audit unless that control can be related to the mitigation of a risk previously identified by the auditor. There is no point in testing (much less relying) on a control that is time honored by tradition but serves no purpose in promoting the fair presentation of financial statements of the specific entity under audit. Repeating some of the examples discussed earlier, management approval of disbursements is a traditional good internal control. However, if the manager doing the approval has no understanding of his or her function (or is powerless to even question a disbursement), a test of this control is of no value (even with a 0 percent error rate) and may, in fact, be indicative of a poor internal control environment.

The discussion that follows highlights techniques that should prove useful in evaluating the effectiveness of the components of internal control and in completing the auditor's risk assessment, as discussed in Chapter 10.

During Phases I and II of the audit, the auditor identifies significant accounts and any perceived audit risks. This should be followed by the identification of the various sources of information and relative reliability of these information sources.

In general, each account will be affected by a variety of accounting processes, and it is important for auditors to realize that the likelihood of errors of audit importance depends

on the type of process(es) affecting the account. Thus, auditors will find it useful to classify sources of information by processes:

- *Recurring/routine processes*: These are accounting applications that process routine financial data (the detailed information about transactions) recorded in the books and records (e.g., cash receipts, procurement and accounts payable, cash disbursements, payroll), which are generally well supported by use of government-wide standard forms.
- *Nonroutine processes*. These are other, less frequently used processes, possibly those used in conjunction with the preparation of financial statements (e.g., involving reconciliations, physical inventories, aging of outstanding receivables, calculating depreciation expense, recording year-end liabilities) that require consideration of costs and activities not recordable or resulting from a standard routine data process and for which government-wide standard forms do not exist.
- *Estimation processes*. These processes reflect the numerous judgments, decisions, and choices made by the auditee in preparing financial statements (e.g., determining allowances for losses, valuing off-balance sheet risk for contingencies such as environmental liabilities, contingent liabilities, credit reform estimates).

This distinction is useful, but auditors should anticipate that certain processes will combine attributes of other processes. For example, the proper determination of accounts payable at the end of a fiscal year typically includes nonroutine activities and procedures in an attempt to obtain a proper transaction cutoff and to ensure that all available information on accounts payable is recorded (e.g., invoices received by operating personnel and not forwarded to the accounts payable department must be inventoried and recorded at year-end).

The next section provides a brief step-by-step approach to the documentation of internal controls in support of effective risk assessments and the identification of relevant internal controls.

## DOCUMENTING INTERNAL CONTROLS

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So far, definitions, oversight agencies, and guidance have been discussed. This is important, useful information on what constitutes sound internal controls, but little has been said about how internal controls are evaluated to determine whether the agency-applied controls comply with guidance and, given the unique circumstances of a governmental auditee, whether the controls are effective. The next discussion addresses the evaluation of internal controls.

The effective evaluation of internal controls hinges on the successful execution of risk analysis techniques, discussed later in Chapter 10. However, risk analysis requires relevant documentation of accounting cycles, processes, systems, and accounts.

During the internal control phase, the auditor reviews documentation developed during the planning phase to conduct the evaluation. For audits that are not first-time audits, the documentation needed for evaluation usually is available after the completion of the planning phase, where the auditor should have noted changes (if any) from prior years.

In recurring audits, the auditors will execute walk-throughs of transactions (if not completed during the prior phase) to confirm their understanding of the system/cycle and then proceed to the execution of evaluation procedures.

For first-time audits, however, it is not likely that an auditor can fully document an agency's financial systems/cycles during the planning phase of the audit. In practice, some of the planning phase's audit effort will necessarily overlap with the internal control phase of the audit process. As long as documentation is properly completed prior to the auditor's execution of risk assessment audit procedures, it matters little whether the documentation is completed during Phase I or II of the audit. The following discussion illustrates an approach to evaluate and test an agency's systems of internal controls.

Documentation of financial management systems must include a detailed examination of the agency's system of internal controls and other aspects of its financial management system. The objective is to determine whether adequate control measures exist and whether the controls have been implemented to prevent or minimize risk and/or detect the occurrence of erroneous and/or unauthorized transactions/events in a timely, cost-effective manner. Systems documentation, the evaluation of the systems of controls, and actual testing of the controls applied in practice are performed during the execution of the first three phases of the audit. The results of these audit procedures include findings, observations, and determination of audit risk. These audit procedures and tasks provide the inputs and knowledge necessary to conclude on the relative effectiveness of controls and to confirm the efficacy of the auditor's decision to rely or not rely on the controls when determining the timing, nature, and extent of audit procedures to apply in the audit. Such an audit approach includes six steps.

*Step 1: Identify and document the event cycle.*

Event cycles are the processes used to initiate and perform related activities, create the necessary documentation, and gather and report related data. In other words, an event cycle is a series of steps taken to get something done (e.g., pay personnel, contract for services, issue grants, etc.). Event cycles are the focal points for documenting and understanding the financial management systems and related internal controls. Accordingly, the first step in the procedure is to identify these event cycles for the particular program or administrative function being reviewed. The initial documentation of event cycles takes place during Phase I (the planning phase) of the audit, and the cycle

documentation is completed during Phase II (the controls phase). The identification of the event cycles is based on information collected from several different sources and a variety of evidence-gathering techniques, as discussed in Chapter 8.

*Step 2: Analyze and evaluate the general systems of controls and controls environment.*

The effectiveness of a system of internal control depends largely on the environment in which it operates. A cycle/process with strong internal controls operating in a weak control environment is likely to have overall weak controls in practice. Conversely, a process with weaker system controls that operates in a sound/strong general control environment can very well have strong controls overall. In the case of a sound system of controls operating within a weak environment, it is likely that controls will be disregarded. Control weaknesses can be overcome or even negated when a system operates within a strong internal control environment.

General systems evaluation, acquiring an understanding of the systems of controls, and making a preliminary assessment of the control environment are performed during Phase I of the audit. During Phase I, the specific attributes of the internal control environment, such as management attitude and policies and procedures, are identified, initially documented, and possibly confirmed on a limited basis. These audit concerns and tasks were discussed in Chapter 8.

*Step 3: Identify and document the individual processing events/activities for each event cycle.*

In this step, each of the individual processing events/activities for each event cycle identified in Step 1 must be noted and documented. The division into individual events/activities facilitates the evaluation of the internal controls for each event cycle. The auditor's documentation for this audit phase includes narrative descriptions and flowcharts for each of the event cycles and significant events and other observed activities.

*Step 4: Evaluate the internal controls within each event cycle.*

For the data related to the internal control environment and additional information on relevant transactions, events/cycles, and the activities occurring within each cycle, the auditor is in a position to evaluate the controls

being used for the various event cycles. This evaluation of internal controls and execution of the related risk assessment is a significant procedure of Phase II of the audit. By reviewing the documentation, the auditor can learn the extent to which the system is documented, may be relied on to safeguard the auditee's assets, complies with laws and regulations, and is capable of producing financial data that are fairly presented in accordance with GAAP. This evaluation enables the auditor to: 1) document and judgmentally determine the level of control risk, 2) determine the extent of reliance that may be placed on internal controls, and 3) determine what, in the auditor's opinion, is the appropriate combination of internal control and substantive testing required (i.e., the actual timing, nature, and extent of auditor tests of internal controls and account balances).

*Step 5: Evaluate tests of internal controls.*

As noted, the documentation gathered in the prior steps enables the auditor to: evaluate the effectiveness of the *design* of the system of internal controls; make *initial* preliminary assertions regarding the reliance that may be placed on the system (subject to the actual detailed test of applied controls that has yet to be done); and determine the extent to which audit efficiency can be achieved by testing internal controls in contrast to conducting more extensive, time-consuming, and costly substantive audit tests of transactions and accounts.

*Step 6: Develop preliminary observations and recommendations.*

The auditor's conclusions, to this point in the audit, should be communicated to the auditee in order to confirm or refute information or perceptions relative to controls that were acquired earlier and to obtain management's views on the auditor's findings up to this point. The timely communication of audit findings/observations on internal controls and related recommendations is essential to support ongoing efforts to improve Federal Government financial management. Thus, auditors should not wait until the completion of Phase III, the testing phase, to report facts of financial management and internal control significance.

During Phase III, the results of the tests developed during Phase II either validate or disprove the auditor's initial assertions relative to the operating effectiveness of the agency's system of internal controls. Depending on the conclusions concerning the operating effectiveness of the internal controls over financial reporting and the controls over compliance with laws and regulations, the auditor will either proceed to complete the planned substantive auditing procedures or, if indicated by test results, revise and increase the extent of previously planned substantive auditing procedures to reduce audit risks to a more tolerable level.

### **COMPLETING AND DOCUMENTING THE AUDITOR'S UNDERSTANDING OF INTERNAL CONTROLS**

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At this point in the audit, the auditor would have:

- Identified and documented significant accounts (Phase I of the audit).
- Identified and documented significant accounting/event cycles, including the processes and activities included in the cycle (Phases I and II of the audit).
- Determined which accounting/event cycles and transactions affect each of the significant accounts (Phase II of the audit).
- Considered the types of processes comprising the accounting/event cycle, such as routine, nonroutine, and estimated sources (Phase II of the audit).

This information enables the auditor to execute his or her risk assessment by:

- Identifying the types of errors that potentially threaten or impact each accounting/event cycle and affect all accounts or account groupings.
- Identifying system characteristics, controls, procedures, or practices may prevent, mitigate, or detect the occurrence of these threats (e.g., relevant internal controls).
- Considering how the risk inherent in each accounting/event cycle could affect each significant account.

Once the auditor determines the internal control risk as it affects each significant account, he or she is in a position to determine whether the system of internal controls can be relied on. The concept of risk assessment is expanded in Chapter 10 to illustrate how, following completion of the risk assessment, the auditor develops detailed audit programs combining, as necessary, tests of internal controls with substantive audit tests, including analytical procedures.



# 10 ASSESSING AND EVALUATING CONTROL RISKS

The third standard of fieldwork states: “The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.”

Consistent with the audit model introduced earlier, during the internal control phase, the auditor must determine whether controls appear to be in place to provide reasonable assurance that the financial data to be reported on is fairly stated.<sup>1</sup> Depending on the results of this evaluation, the auditor decides the extent to which controls are to be tested to provide the “sufficient appropriate audit evidence.”

This chapter expands on the internal control evaluation process introduced earlier and provides a controls risk assessment model that has proved useful in the execution of audits. This chapter concludes the discussion of the control phase of an audit that began in Chapter 9. An important output of this phase of the audit is expanding on the audit planning and programs developed earlier and deciding on an audit approach supported by detailed audit programs. The detailed audit programs guide the execution of both tests of internal control and the substantive testing of accounts balances.

## ASSESS CONTROL RISKS

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The auditor must formally *assess control risks*, that is, the risks that a material misstatement could occur in a financial statement assertion and not be prevented or detected on a timely basis by the system of internal control. In assessing control risks, the auditor is making an estimate of the relative effectiveness of the existing internal control system.

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<sup>1</sup> The Government Accountability Office’s guide, *Federal Information System Controls Audit Manual*, is not an audit standard; its purpose is to: (1) inform financial auditors about computer-related controls and related audit issues so that they can better plan their work and integrate the work of information systems (IS) auditors with other aspects of the financial audit; and (2) provide guidance to IS auditors on the scope of issues that generally should be considered in any review of computer-related controls.

### Levels of Control Risks

In assessing control risks, the auditor's interest must be focused on the extent to which the government's control system is preventing or detecting incomplete, inaccurate, or invalid transactions.

The Government Accountability Office's (GAO's) *Financial Audit Manual (FAM)* provides a practical template for assessing control risks by identifying three levels of such risks. The level of control risk is based on the auditor's preliminary evaluation of internal control for each assertion, significant line item, and significant account. Based on his or her evaluation/belief, the auditor classifies control risks as:

1. *Low*. Controls "will" prevent or detect errors that individually or in the aggregate will result in misstatements in excess of design materiality.
2. *Moderate*. Controls "will more likely than not" prevent or detect errors that individually or in the aggregate will result in misstatements in excess of design materiality.
3. *High*. Controls "will more unlikely than likely" prevent or detect errors that individually or in the aggregate will result in misstatements in excess of design materiality.

Both GAO and American Institute of Certified Public Accountants (AICPA) guidance provide that the auditor must document conclusions regarding assessed levels of control risks for each relevant system/cycle, group of transactions, and/or account balance. For audits in accordance with *Government Auditing Standards* (Yellow Book) standards, the auditor's assessment should be documented in his or her planning documents and specifically the account risk analysis (ARA).

As a practical matter, a low risk determination usually requires more audit evidence supporting the presence of mitigating factors such as internal controls. This is not to say that a high risk determination need not be documented. In most, if not all, instances, a high risk determination relates to a control deficiency that must be reported to management and possibly to individuals charged with governance. Thus, a determination of high risk should not be arrived at lightly. The auditor must have facts well documented/verified to ensure not only audit efficiency but the avoidance of needless embarrassment.

Finally, during the execution of this phase, the auditor must remember that prior to testing, his or her assessment of risk is a preliminary estimate and subject to change if later tests disclose circumstances, conditions, and events indicating that the assessed level of risk was too low or that control deficiencies may have led to misstated financial statements.

### Definitions and Classifications of Internal Control

In some circumstances, internal control deficiencies may be substantial, requiring the auditor to classify them as significant deficiencies or material weaknesses.

A deficiency in internal control exists when there is a condition in the design or operation of an agency's system of internal control that allows misstatements to occur (e.g., allows transaction errors that cannot be prevented or detected by operating personnel in a timely manner). Substantial deficiencies are classified as significant deficiencies or material weaknesses depending on the magnitude of the deficiency.

The AICPA's definitions for these conditions as set forth in U.S. Auditing Standards—AICPA (Clarified) (AU-C) 265.07 appear next.

A material weakness is a deficiency or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.

A significant deficiency is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

GAO's *FAM* (Section 580.32) adopts the AICPA's concepts just discussed but provides for somewhat different definitions:

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected

A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. generally accepted accounting principles (GAAP) such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

Office of Management and Budget (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements* (as amended in 2008), provides yet another variation on the same themes:

Material weakness is a significant deficiency, or combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the financial statements will not be prevented or detected. This material weakness definition aligns with the same material weakness definition used by management to prepare an agency's FMFIA [Federal Managers' Financial Integrity Act of 1982] assurance statement. (Paragraph 2.11)

Significant deficiency is a deficiency in internal control, or a combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. (Paragraph 2.13)

Auditors may choose which definition is easier to follow. Arguably, GAO and OMB definitions are easier to follow than the AICPA's definitions. In more practical terms, if your audit conforms to any of the definitions just cited, you will be in compliance with all three standard-setting bodies.

### Additional OMB Requirements

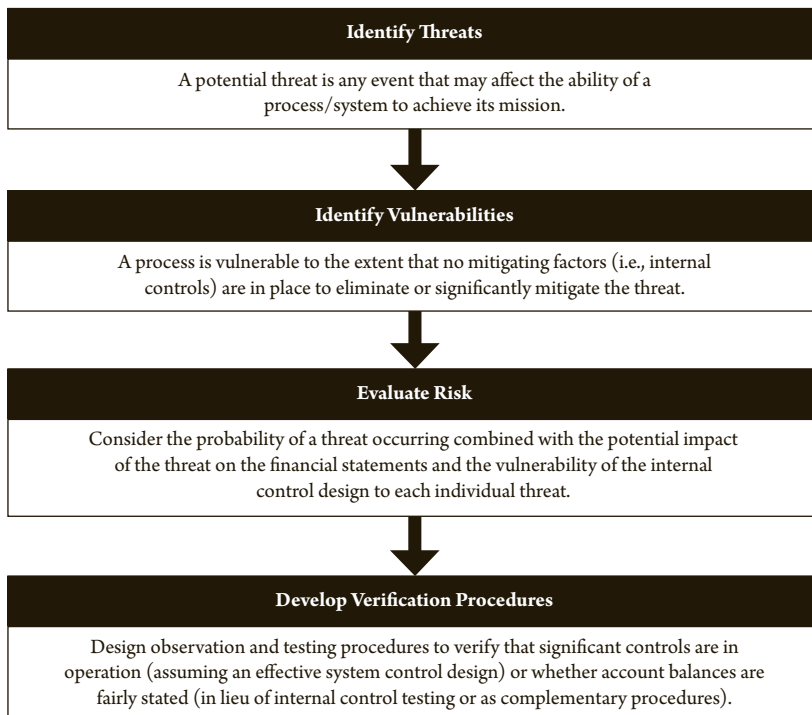
OMB's definition of internal control, as it relates to financial reporting, essentially parallels the AICPA's definition. However, OMB adds as a specific objective of internal controls these details:

Compliance with Applicable Laws, Regulations, and Government-Wide Policies: Transactions are executed in accordance with laws governing the use of budget authority, Government-wide policies, laws identified by OMB, . . . and other laws and regulations that could have a *direct and material effect on the Basic Statements*.

The need to comply with laws and regulations, when noncompliance could materially affect the financial statements, is implied in the AICPA's definition of internal control over financial reporting. However, OMB expands on the definition, in essence, by reserving the right to identify specific laws and regulations that should be supported by effective controls, thus removing the option for auditor judgment as to which laws and regulations will be tested.

A risk assessment is a thought-intensive judgment process requiring a careful consideration of documentation gathered earlier and the potential implications/effects of the processes, cycles, systems, or activities documented on internal control risks.

The risk assessment methodology discussed in this section is summarized in the following illustration.



The first three activities depicted in the graphic enable the auditor to define and document existing internal control risks, as required by AICPA and GAO guidance, and to develop an efficient audit approach that, where possible, capitalizes on existing system strengths (e.g., by testing controls) while focusing the auditor's efforts on those areas that may not be supported by strong controls.

The model departs from a more traditional audit approach by addressing process or system threats instead of internal control objectives. This approach is strictly a judgment call. Experience dictates that the identification of threats (the flip side of objectives) focuses the auditor's attention on the specific characteristics of the process/system being audited. All too often, identification of objectives becomes a recitation of good characteristics of any system that is the result of memorization and not the critical evaluation of the process or system. The model does not preclude the identification of objectives. As will be seen in connection with the audit of account balances where objectives are typically more diverse, our recommended approach combines the identification of threats and objectives.

The next discussion illustrates how risk assessments may be executed and includes techniques that have been found useful in the execution of financial statement audits.

### **Identify Threats**

Risk can never be eliminated, but with proper controls it can be reduced to a reasonable level. The initial effort in our assessment is to identify what can go wrong in the operation of a given process or system. It is important that threats be identified initially without considering whether controls are already in place. This practice reduces the possibility of threats being prematurely eliminated from consideration without a full evaluation of mitigating controls and knowing the full implications of the threat on the financial statements. Further, it enables a reevaluation of the threat when subsequent testing indicates that the mitigating control is not fully operational or effective.

The identification of threats requires equal parts imagination and experience. Extreme flights of fancy are not very productive, but neither is rigidity of thought. Risk assessments should be supervised by more senior members of the audit team but should also include contributions from more junior personnel. Experience is invaluable when it comes to the identification of threats, but sometimes it also hinders original thought. The identification of threats is facilitated by interactive discussions among audit team members with different levels of experience and assorted specializations. In identifying threats, the auditor will find the concepts of routine, nonroutine, and judgmental processes very useful. In general, the less routine and more judgmental the process is, the higher the level of risk and the number of possible threatening events.

The audit team meetings required by AU-C 315.11, *Understanding the Entity and Its Environment*, and AU-C 240.15, *Consideration of Fraud in a Financial Statement Audit*, provide a good starting point regarding the identification of threats.

### Identify Vulnerabilities

Having identified possible threats, the auditor considers whether the process includes procedures that eliminate or mitigate the threats (i.e., whether internal controls are in place that effectively reduce internal control risks to a reasonable or tolerable level). Representative *general* internal controls that the auditor considers include these:

- Internal control environment
- Information technology (IT) practices
- Segregation of duties
- Audit trails
- Availability of competent evidential matter (e.g., invoices, receiving reports, purchase orders)
- Knowledgeable, trained personnel (particularly in connection with nonroutine and judgmental processes)
- Adequacy and completeness of documented operating policies and procedures

In identifying internal controls, the auditor often refers to “best practices” as documented in formal checklists and other guidance. Virtually every auditing firm or agency has developed (or adopted) an internal control guide or checklist in one form or another. In addition, accounting and auditing literature is filled with such checklists. Some of the most comprehensive checklists can be found in GAO publications, including systems requirements checklists and the Internal Control Management and Evaluation Tool GAO-01-1008G (August 2001). There is, however, no substitute for audit judgment. As GAO stresses in every checklist or guidance issued, its documents are intended to serve as aids to auditors and managers, not as substitutes for independent judgment.

Auditors are cautioned to consider the real impact of each control. Too often, auditors assume that strong controls exist simply because of the existence of a procedure indicative of best practices. For example, a time sheet is one such best practice; however, its mere existence does not lessen the threat of phantom or nonexistent employees or prove that an employee actually worked the hours stated on the time sheet. Auditors must recognize that time sheets are but sheets of paper that anyone can complete. Without a requirement that time sheets be approved and/or reviewed by an appropriate member of management, there is no added assurance that an employee actually worked the hours stated on the time sheet. Further, without proper controls over authorization for the addition of new employees, including adequate segregation of duties of the approving manager, there is no assurance that the employee actually exists. In addition, without proper audit trails (i.e., approving signatures, properly controlled time stamps), auditors cannot test the control, although they may be able to observe compliance as part of a number of tests. Finally, in a poor internal control environment, the use of time sheets and the accompanying approval and audit trails could quite possibly provide no assurance that the threat has been mitigated.

By contrast, a process that is not supported by time sheets but that issues periodic and timely reports of payroll expense, including payee and hours worked, could be a significantly better internal control. This would be the case if the report were issued to a well-motivated manager operating in a strong internal control environment with proper segregation of duties.

### Evaluate Risk

The final determination of risk is generally based on the auditor's assessment of these factors affecting each threat:

- *The likelihood that the threat may occur.* For example, earthquakes may represent a threat to any process. However, a process operating in the State of New York is less susceptible to an earthquake than a process operating in the State of California. Thus, a weakness in ensuring continuity of operations in connection with the threat of a major earthquake is of greater consequence for processes in California, since the likelihood of occurrence is higher.
- *The impact of the threat on the financial statements.* In this case, weaknesses surrounding major cash disbursements, such as a payroll process, are clearly of more concern to the auditor than weaknesses surrounding petty cash disbursements.
- *The extent to which the threat is mitigated.* Having identified mitigating controls in the assessment of vulnerabilities, the auditor must determine the extent to which the threat can bypass existing controls.

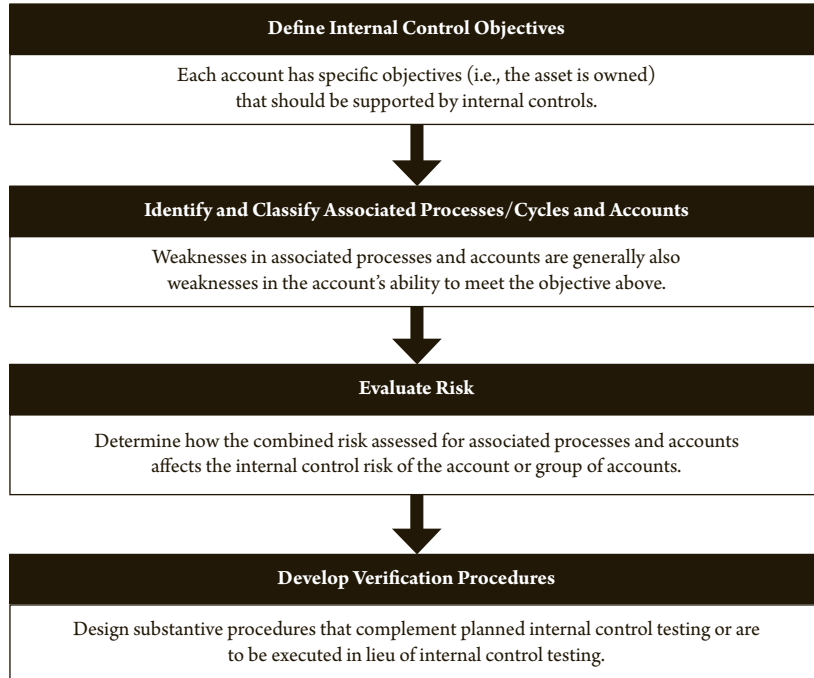
The combined consideration of the threat's probability of occurrence, its potential impact, and the vulnerability of the process provides the basis for the auditor's assessment of internal control risks (i.e., high, moderate, or low, following GAO's classification).

### ASSESS ACCOUNT-LEVEL RISK

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During planning and the early activities of the internal control phase, the auditor identifies significant accounts or groups of accounts. As was the case with accounting processes/cycles, the auditor analyzes these accounts and evaluates the internal controls being applied by the agency. These accounts and groups of account evaluations are an extension of the risk assessment discussed earlier. Accounting cycles produce account balances by processing transactions, and the reliability of the account balance is affected by the internal controls associated with the accounting process/cycle or system.

Financial statements present data taken from account balances. Obviously, extending the risk assessment to include account balances is essential to obtaining competent evidential matter to support the auditor's assertions. The account-level risk assessment typically follows the pattern shown next:



### Define Internal Control Objectives

The first step in the evaluation consists of identifying the objectives (from a financial reporting perspective) of each account. The use of objectives to initiate the process instead of threats (as we did for processes/cycles) is a purely subjective one, but we believe that it is easier to relate an account objective to a financial statement assertion. In identifying objectives, the auditor may find it helpful to consider:

- Ownership and legitimacy
  - The asset is real, representing the result of a legitimate transaction and supported by proof of ownership, such as a title or a contract supporting an account receivable.
  - The liability represents a legitimate obligation of the entity as a result of a reasonable, allowed, and legal transaction with the creditor.
- Physical existence and safeguarding
  - The asset currently exists, and a process is in place to ensure that the asset is not stolen (if physical property) or otherwise rendered valueless (e.g., unauthorized or accidental record/data loss or write-off in the case of receivables).
  - The liability is removed when paid (or the obligation is otherwise fulfilled/terminated), and there is a process to ensure that all liabilities are recorded and



protected against unauthorized or accidental additions, deletions, or data manipulation.

- Fairness of classification. Processes exist supported by documentation to ensure that transactions affecting the account are recorded in accordance with GAAP
- Fairness of account valuation. Encompasses all of the above items, and usually requires processes and documentation that *periodically* assess the proper valuation of the account. Examples might include:
  - Estimation processes to revalue assets, such as an account for bad debts or a reserve or write-off for obsolete or damaged inventory.
  - Estimation processes to ensure that year-end accounts payable or periodic accruals are fairly stated.

### **Identify Accounting Processes and Affected Accounts**

In this step of the assessment, the auditor identifies processes and accounts that affect the specific account being evaluated. In general, the auditor considers:

- Routine accounting processes (e.g., cash disbursements, cash receipts, etc.).
- Nonroutine accounting processes (e.g., reconciliation procedures, supervisory monitoring procedures, etc.).
- Estimation processes (e.g., reserves for bad debts, reserves for contingencies, other valuation reserves, etc.).

The auditor will have already identified and documented most processes/cycles associated with the account; however, each general ledger account is subject to other (usually nonroutine or estimation) procedures designed to ensure the fair presentation of the account balance. Typical examples of nonroutine and estimation procedures that are unique to an account or group of accounts are listed next.

- Reconciliation of account balances (e.g., cash, accounts payable/receivable, physical inventories)
- Periodic account reviews by management
- Availability and analysis of agings (e.g., for accounts receivable, accounts payable)
- Accruals and other period-end cutoff procedures (e.g., accrued salaries, accounts payable)
- Periodic physical inventory counts
- Computation of depreciation expense (or related analytical procedures if process is automated)

It is possible that these processes were not identified with the more routine accounting cycles during the planning and early stages of the internal control phases. Thus, this step in the risk assessment process should ensure that all relevant processes are identified.

Finally, the auditor should be aware of the relationships between accounts, as weaknesses or misstatements in an associated account may impact the account under evaluation. Thus, for example, a loss loan reserve (usually the result of an estimation process) is affected by the accuracy of data related to the associated loans (e.g., account balance, aging, terms, etc.). Similarly, an accrued interest payable account is affected by the details of the associated debt payable account (e.g., balance, interest rate, maturities).

### **Evaluate Account Risk**

After defining the internal control objectives of the audited account and the related processes, the auditor will be in a position to establish whether these processes support the accomplishment of objectives identified. To the extent that the internal control risks of the associated processes were assessed as low, it may be possible simply to test relevant internal controls to support the auditor's assertions without executing any complementary substantive procedures (or by performing only minimal substantive procedures, such as selected analytical procedures).

Conversely, where controls of the supporting processes were assessed as high, internal control testing may serve no purpose, and the audit of the account will require substantive auditing procedures to validate the account balance (or to ascertain the correct balance and propose audit adjustments). The development of an appropriate testing approach is discussed next.

## **DEVELOP AUDITING PROCEDURES**

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Having completed the risk assessment, the auditor is in a position to develop audit testing procedures. As addressed next, the optimal testing approach must consider specific Federal requirements as well as audit efficiency.

### **Oversight Guidance**

The AICPA requires that an auditor obtain an understanding of internal control. It does not, however, require that the auditor test internal controls regardless of his or her evaluation of internal control risks. GAO requirements in this regard are similar. However, OMB Bulletin 07-04 guidance (not GAO Yellow Book standards) is more specific than either AICPA or GAO guidance. OMB guidance in Bulletin 07-04, paragraph 6.8, states, "For those internal controls that have been properly designed and placed in operation, the auditor will perform sufficient tests to support a low assessed level of control risks."

Traditionally, AICPA guidance has stressed audit efficiency and allowed auditors to bypass internal control testing if other procedures were more practical or efficient in the auditors' judgment. By contrast, both GAO and OMB have always emphasized the importance of internal controls because of the fiduciary nature of government operations.

In requiring the testing of internal controls even when internal control risks are below the maximum, OMB is simply asserting its belief that the public deserves reassurance that assets entrusted to Federal Agencies are properly safeguarded. Therefore, verifying that Federal systems are free of significant internal control deficiencies is an important consideration in the execution of annual audits of Federal Agencies.

It is interesting to note that while current AICPA guidance still does not require audit opinions on internal controls, the Sarbanes-Oxley Act (SOX) of 2002 does require issuance of an auditor's opinion on internal controls (as well as one on management's representation on the adequacy of internal controls). Thus, in effect, at least for public companies, there is a requirement for control testing.

### **Develop Test of Relevant Internal Controls**

In developing the types of tests, an auditor must consider representative general internal controls, such as these:

- Entity-level controls, including the control environment
- IT general controls, on which other controls are dependent
- Adequacy of cycle documentation (including both IT systems and manual procedures)
- Segregation of duties
- Audit trails and availability of competent evidential matter (e.g., invoices, receiving reports, purchase orders) for transactions processed by the system/cycle
- Knowledgeable, trained personnel
- Adequacy and completeness of accounting policies and accounting principles to be applied (and supported by the systems/cycles)

General controls are important because, without them, there is little to be gained by testing more specific controls associated with each process/cycle. Although some general controls can be tested as part of a test of transactions (e.g., segregation of duties, presence of effective audit trails), many of the key controls, such as adequacy of documentation and availability of competent personnel, can be tested only through observation and the exercise of audit judgment.

After considering the effectiveness of general controls, the auditor proceeds to evaluate the individual controls affecting each subsystem/cycle and relevant to the audit assertions and significant accounts or groups of accounts. Auditors generally address these controls within each major process/cycle or application:

- Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures embodied in the financial statements (e.g., authorization for purchases)
- Controls over the selection and application of accounting policies that are in conformity with GAAP (e.g., valuation and reserve accounts, depreciation)

- Antifraud programs and controls
- Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates; this includes reconciliation procedures for balances with Treasury, accounts receivable, accounts payable, and physical inventories, among others
- Controls over the financial reporting process (e.g., how the individual process/cycle complies with Federal guidance, such as OMB)

In addition, auditors look for the existence of more specific controls that meet the requirements of any given cycle. Thus, by way of example, in the case of processes and procedures related to accounts payable, auditors also determine whether sufficient controls are in place to achieve objectives such as:

- Purchases are made only from responsible parties authorized as vendors and in accordance with Federal acquisition regulations.
- All cost expenses accruing are properly identified (including the name and address of the vendor).
- Disbursements are properly monitored, and appropriate action is taken to ensure compliance with Prompt Payment Act requirements.
- Proper cutoff procedures are followed to ensure the fair presentation of payables and expenses.
- Costs and expenses are accounted for in accordance with GAAP.

In the case of revenue-related activities, auditors determine whether sufficient controls are in place to achieve objectives such as:

- All revenues, including taxes and fees, accruing to the auditee are properly identified.
- Collections are properly monitored, and appropriate action is taken on delinquencies (e.g., dunning procedures).
- Revenues are accounted for in accordance with GAAP.

With the completion of these procedures, auditors are in a position to determine:

- Whether guidance requires that the cycle process or system be tested (i.e., OMB Bulletin 07-04 requirements when the internal controls design is deemed to be effective and the internal control risks are low).
- Assuming controls warrant testing (or must be tested), which controls should be tested to validate the auditor's risk assessment and to verify that account balances are achieving the objectives discussed earlier (i.e., ownership, legitimacy, existence, safeguarding, and fairness of classification and valuation).
- The nature of the tests (e.g., observation, inquiry, test of transactions).

## FINALIZE AND DOCUMENT THE AUDIT APPROACH

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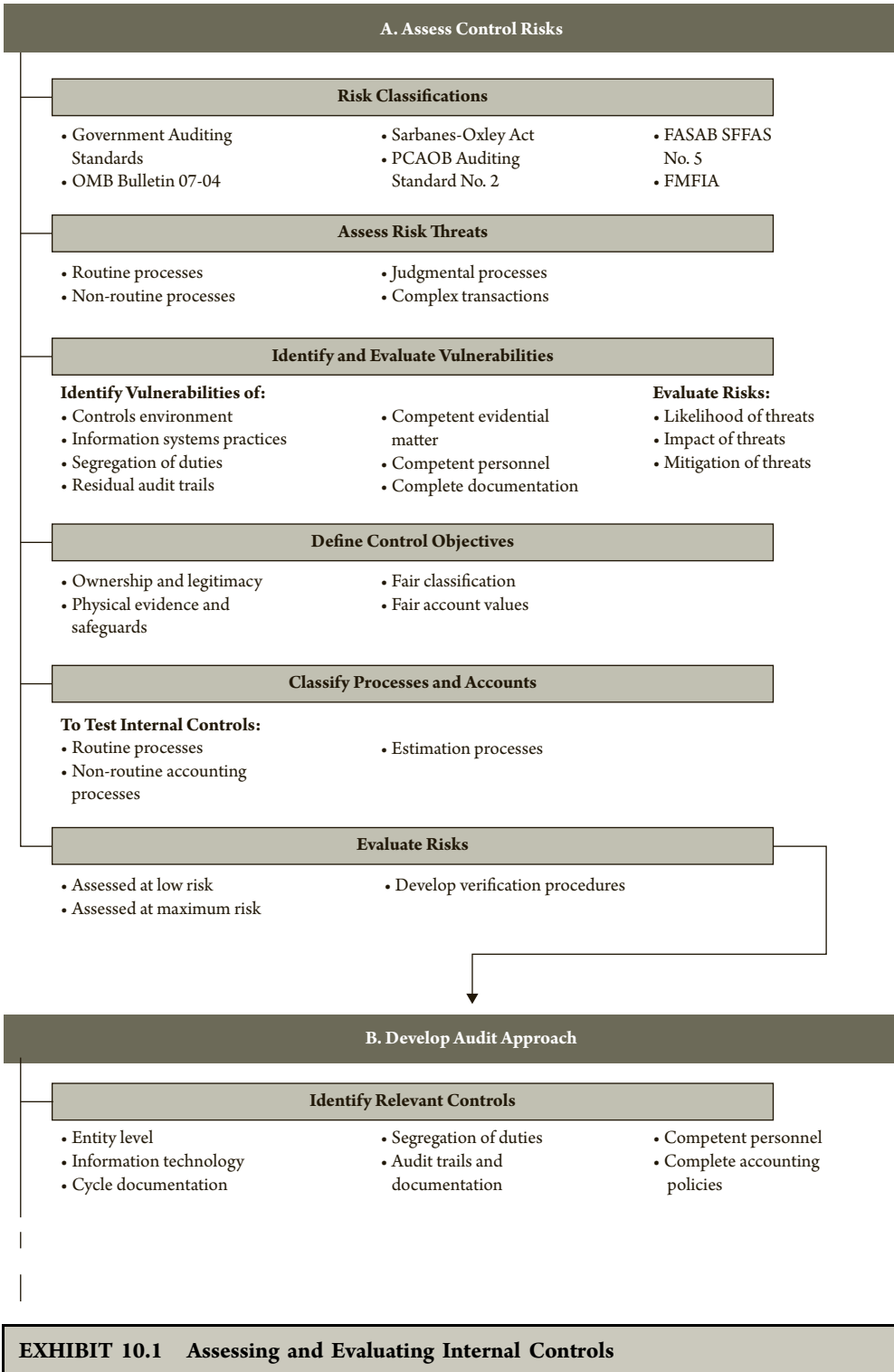
Based on the risk assessment, and within the constraints imposed by guidance, auditors develop an audit approach. Such an approach typically includes some or all of these tests:

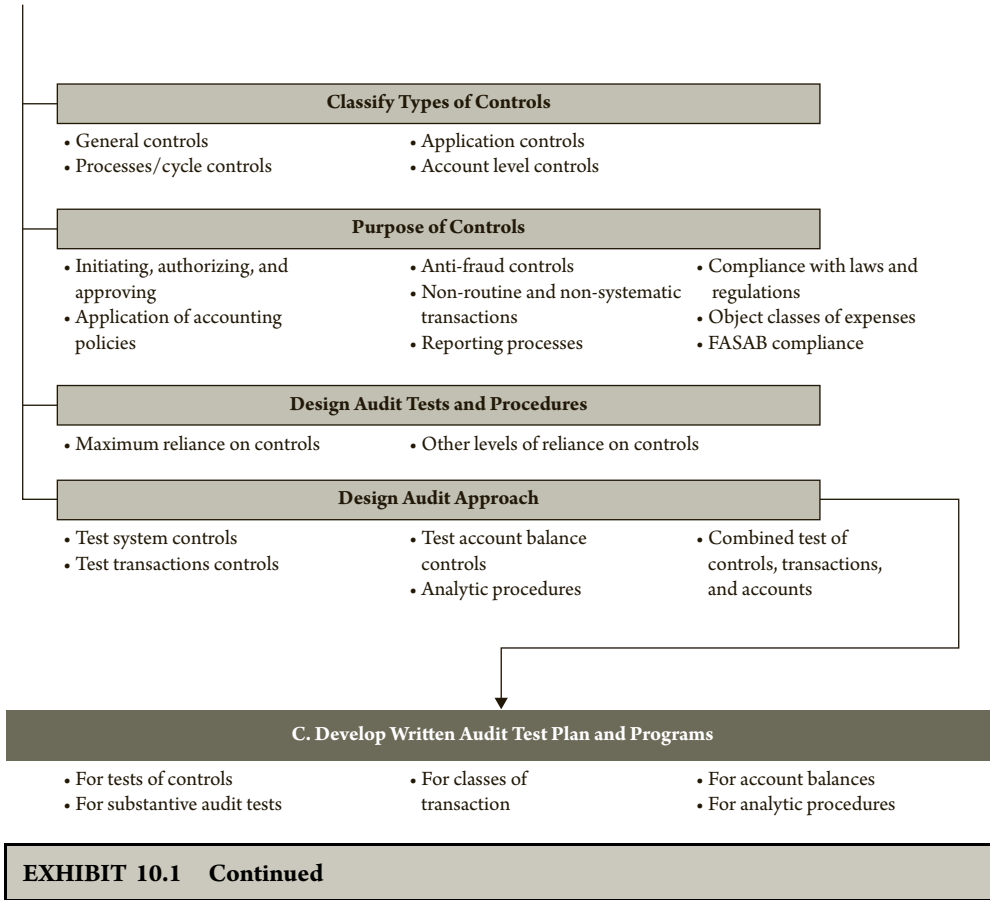
- *Test of internal controls.* Generally, for systems where internal control risks are evaluated below the maximum, auditors find it efficient to test selected controls.
- *Substantive testing—tests of account balances.* Where control risks are at a high or moderate level, auditors typically develop auditing procedures with the intention of obtaining sufficient competent evidential matter to support their assertions on the financial statements. Where controls are assessed at a moderate or low level, these tests will likely complement test of control procedures.
- *Substantive testing—analytical procedures.* Analytical audit procedures require auditors to look at certain relationships within financial data (e.g., analyzing trends; comparing financial data to the prior year's; comparing account balances and trends to similar entities; and considering the relationship between certain accounts, such as sales to inventory or accounts receivable, fringe benefit expense to payroll expense accounts payable as a percentage of total expenses, etc.). Analytical procedures are a requirement of the audit planning and review process and can be used as substantive procedures, usually in combination with tests of internal controls and/or tests of account balances.
- *Combined test of controls and account balances.* In certain instances, auditors determine that the most efficient approach to auditing a given account or group of accounts is substantive (e.g., account balance) testing. However, it is also possible that these accounts are supported by a system of internal controls that was assessed by auditors as effective (e.g., control risks assessed as low). In these instances, the best approach may be to combine the account balance testing with a related test of internal controls. This approach satisfies both the efficiency objective and the need to comply with OMB Bulletin 07-04 requirements.

Additional testing characteristics are discussed in the next chapter.

Upon completing the audit approach, auditors update, as necessary, update ARA and the audit strategy/audit plan developed in Phase II (i.e., the understanding of controls and evaluation of controls phase). In addition, the more senior members of the audit team must develop or update audit programs covering the tests of controls and substantive procedures to be performed in the testing phase of the audit. The design of an effective audit program is essential to the execution of an effective and efficient audit. A well-designed audit program enables the effective utilization of more junior personnel, supports the development of relevant audit documentation, and facilitates the monitoring of audit team members.

Exhibit 10.1 depicts the control risks process.









# 11 TEST OF CONTROLS, TRANSACTIONS, AND ACCOUNTS

Audit procedures are designed to gather evidence and should be viewed as processes that continuously seek to obtain and evaluate sufficiently appropriate audit evidence. However, in practical terms, the bulk of appropriate audit evidence supporting the auditor's financial statement assertions is the result of testing conducted during Phase III of the Federal Government's audit model. The testing phase encompasses both internal control and substantive testing.

Throughout the audit process, the objective is the continual assessment and validation of the nature of *audit risk*, which, in its simplest form, is the risk of the auditor unknowingly issuing a clean audit opinion when the financial statements are materially misstated. AU-C 200 states that audit risk encompasses:

- *Inherent risks* relate to the susceptibility of a process or account to be misstated. For example, estimates such as those required by the Federal Credit Reform Act require complex calculations that are more likely to include errors, than, for example, simple payroll accrual estimates at the end of a reporting period. Similarly, certain assets, such as cash, are more susceptible to theft than others. Finally, certain assets are subject to spoilage unless consumed/disposed of on a timely basis. Inherent risks also arise from factors external to the agency such as changes in congressional funding levels and/or congressionally mandated change in the program's mission. Changes such as these could affect the value of, or render obsolete, assets such as inventories and other property that the agency had created for future use, but which was rendered valueless or nearly so as a result of the change in funding or program.
- *Control risks* relate to the possible occurrence of material misstatements that are not prevented or detected on a timely basis by the auditee's internal control processes. In other words, for some reason(s), the "prescribed" internal controls failed to work. Control risk also includes accounts, processes, cycles, or systems that are susceptible to certain threats that are not mitigated by the presence of effective internal control practices and procedures that reduce the likelihood of the threat to a reasonably low level. (Control risks cannot be reduced to zero, given the inherent limitations of any system of internal controls.)

- *Detection risks* relate to the auditor's failure to detect a misstatement. A sound audit approach executed by competent personnel with the requisite skills and experience necessary for the tests included in the approach should reduce this risk to a reasonable level. Since the auditor does not examine 100% of all transactions, this risk is always present. However, it is the auditor's responsibility to develop a sound audit approach to minimize detection risk.

Frequently, careful and informed interviews of agency executives, program managers, financial personnel, and data processing staffs provide early clues to client attitudes, pressures, problems, contingencies, and high-risk areas not readily apparent from examinations of general ledger (GL) accounts or not noted in tests of detailed transactions. Throughout the audit, but particularly in regard to the testing described in this chapter, the audit team must continually reflect on the impact of projected misstatements, not just discoveries and correction of specific errors.

Exhibit 11.1 highlights several aspects and issues concerning testing applications that should, and in some cases must, be used when conducting an audit pursuant to *Government Auditing Standards* (GAS; the Yellow Book).

## TYPES OF TESTS

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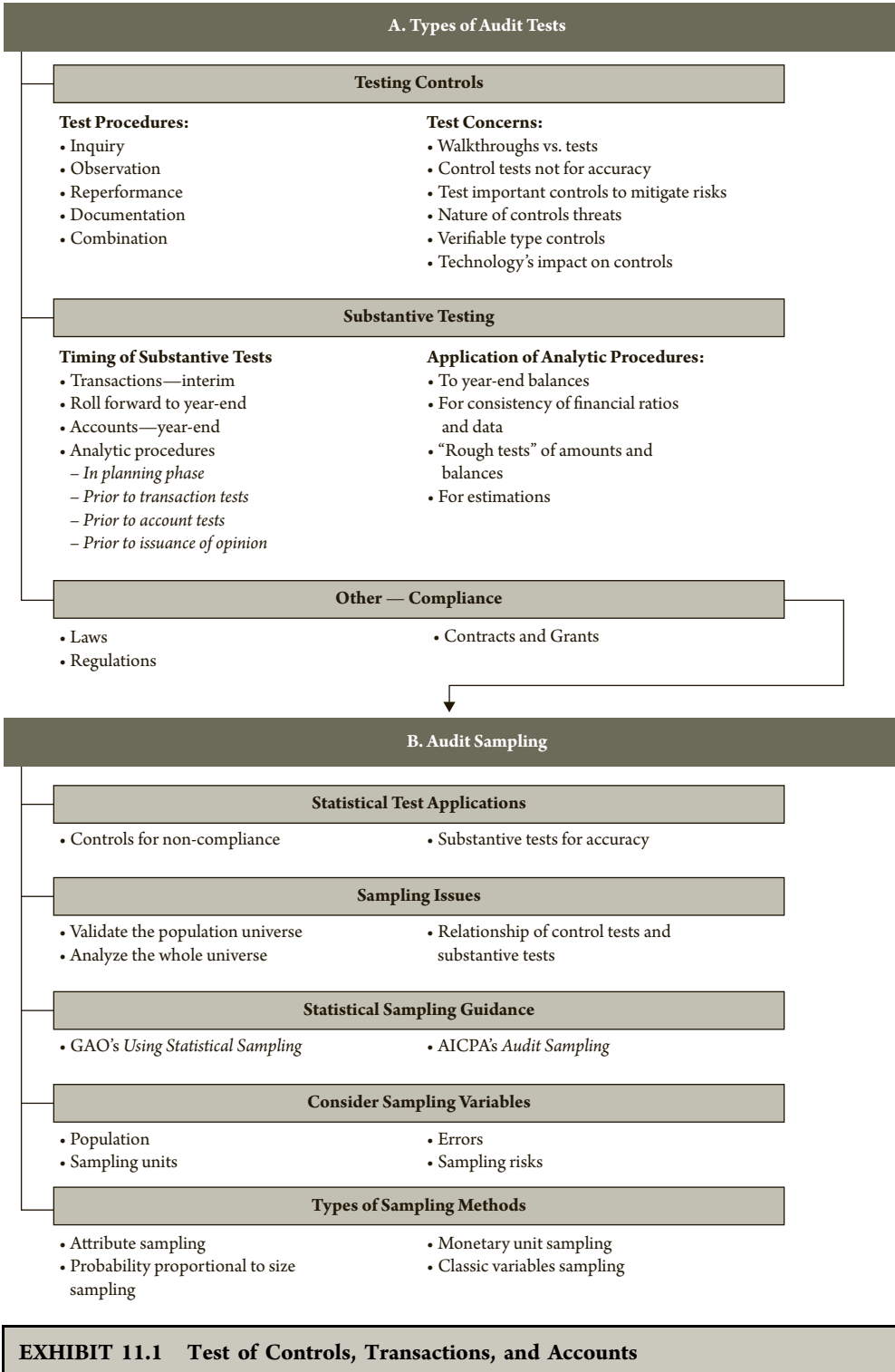
Audit testing traditionally takes one of two forms: internal control or substantive testing. In government auditing, Federal guidance provides for a third type of testing: testing of compliance with laws and regulations.

### Tests of Controls

Tests of internal controls are designed to verify whether the internal controls identified during the planning phase of the audit, in the auditor's evaluation of the system design, are, in fact, operating and/or being complied with in practice. As such, a test of internal controls is appropriate only (and can be effective only) if, in the auditor's judgment, the control being tested can effectively detect or prevent an event or transaction that could negatively affect important assertions.

### Substantive Tests

Substantive tests are designed to validate an account balance by direct validation of the account (e.g., physical observation of property, review of documentation such as invoices to verify assigned costs, direct confirmation of balances with third parties, etc.) or by developing an independent estimate of what the account balance should be (e.g., by applying statistical techniques or executing analytical procedures) and comparing with the data recorded in the auditee's records. While the auditor may determine that a substantive test is a more practical means of obtaining appropriate audit evidence, he or she must still



assess the impact of internal controls on assertions, transactions, or accounts that are subjected only to substantive audit procedures.

### **Tests of Compliance with Laws and Regulations**

Noncompliance with Federal financial laws and regulations may have a direct impact on an entity's financial statements. For example, noncompliance with an environmental law may result in a contingent or possibly actual liability that needs to be recorded or disclosed according to the specific circumstances. In this respect, governmental auditing is similar to commercial auditing, and this type of compliance can be considered in connection with specific internal controls and the internal control environment. However, the Office of Management and Budget (OMB) and the agency itself will also identify certain laws and regulations that may not have a material impact on the financial statements of the agency but that nevertheless should be considered by the auditor. It is important for the auditor to be aware of these regulations and to test compliance, as required by the guidance.

## **TESTING INTERNAL CONTROLS**

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*Tests of controls* require the application of audit procedures with the objective of validating (or disproving) the *operational effectiveness* of the internal controls. The test is designed to determine whether controls are, in fact, operating as designed. To the extent that testing confirms that controls are operating as described in the auditor's documentation of the system design, the auditor obtains the necessary support to validate the initial control risk assertion (e.g., level of assurance) and is in a position to continue with the execution of the audit approach developed during the internal control phase.

No definition of *operational effectiveness* exists in law, OMB or Treasury Department regulations, the accounting and audit guidance of the Government Accountability Office (GAO), or the generally accepted accounting standards (GAAS) of the American Institute of Certified Public Accountants (AICPA). However, auditors must establish the operational effectiveness of controls if reliance on internal controls is to serve as a tool in support of the audit assertions. In order to conclude that controls are *operationally effective*, auditors must consider whether the internal controls are:

- An effective deterrent against theft, misuse, waste, or accidental destruction of physical assets (e.g., property, plant, and equipment) and nonphysical assets (e.g., financial and nonfinancial systems, software, other records supportive of financial and operational management and reporting).
- An effective safeguard over the collection, recording, processing, and ultimate reporting of financial and nonfinancial data (regardless of whether the systems are manual or electronic in nature, the information is recorded at remote sites or

centrally, by professional or nonprofessional, financial or nonfinancial personnel, at the auditee's sites or at outsourced locations).

- Effectively providing reasonable assurance of prevention or detection for instances of noncompliance with laws, regulations, contracts, and grants that have a direct and material effect in determining financial statement amounts or other data significant to the audit objectives.

Conversely, where tests disclose that controls are not effective or were not fully operational throughout the year, the auditor must revise the audit approach. In other words, negative or unsatisfactory test results oblige the auditor to reassess the evaluation of internal control risk. To the extent that the auditor reduces the reliance on internal controls, he or she must revise the audit approach accordingly.

Typically, when the initial assessment of control risk is proved wrong, the auditor is required to develop additional substantive audit procedures to compensate for the newly determined internal control risk. However, in certain instances, the auditor may conclude that the magnitude of the internal control weakness or the nature of the transactions or accounts being tested is such that it would not be possible to execute sufficient substantive tests to compensate for the control weakness. When this is the case, the auditor will have to issue a qualified opinion or, if warranted, a disclaimer.

## HOW TO TEST CONTROLS

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Tests of controls must provide assurance on the operational effectiveness of the five control components, as set forth in AU-C 315.A50 (i.e., control environment, risk assessment, information and communication, control activities, and monitoring) in relation to each transaction cycle or accounting application of a government entity.

Audit procedures typically applied in testing the effectiveness of a government's controls over transactions and accounts include auditor inquiries, auditor-documented examinations, auditor observations, and auditor recalculation of auditee data. Common test procedures include:

- *Inquiry: Ask those who do it.* Governmental personnel with firsthand knowledge and who are directly responsible for implementing the designed controls must be interviewed. In conducting inquiries, it is important that the auditor interview those with operational knowledge as well as a sound corporate or institutional memory (i.e., an understanding of the entity's history based on years of experience working for the entity). Auditors consider inquiry to be an essential audit procedure. However, all knowledge acquired through inquiry must be corroborated by other audit procedures. Healthy skepticism is as necessary in the audit of

government agencies as it is in the audit of commercial enterprises; reliance cannot be placed solely on inquiry.

- *Observation: Witness control-related activities.* The auditor might note the performance of certain control-related activities only by observing the actual act by auditee personnel. Examples could include learning of unauthorized personnel who routinely enter restricted computer spaces, managers who consistently delegate check-signing responsibilities to subordinates, or supervisors who habitually sign off on time and attendance records days after payrolls are processed and backdate their actions. Experienced auditors recognize the importance of observation. Even the most well-intentioned employee will occasionally, and inadvertently, develop bad habits, such as failing to secure assets and information, not following restricted access rules, and the like. A competent auditor does not spend all of his or her time at a desk. Auditing by walking around (the combination of observation and inquiry) often discloses important facts and conditions that might otherwise be missed by the execution of more traditional documentation, evaluation, and testing techniques.
- *Reperformance: Repeat, recheck, and recalculate auditee work.* Sometimes recalculation and rechecking are the primary audit procedures for validating the operational effectiveness of certain control activities. For example, reperformance or recalculation is required by the auditor to validate the propriety of fees billed by a regulatory agency or amounts paid to vendors for goods or services received.
- *Documentation: Follow the paper trail.* In earlier phases, the auditor should have identified and obtained copies of the various forms that document the control process of each of the government's transaction groups or accounting applications (e.g., budgeting, tax billings, cash receipts, cash disbursements, payrolls, contract awards, debt issuance). Following the audit trail (often in combination with reperformance and the other techniques just listed) is an essential element in the execution of a sampling plan. Whether derived statistically or judgmentally, the sampling plan applied in the testing of controls requires that the audit trail be examined for a creditable number of transactions within each of the transaction groups or accounting applications. The objective is to confirm that the timing, amount, purpose, quantities of recorded transactions, and appropriateness of accounts charged for the tested transactions are supported by documented authorizations, approvals, and sign-offs.

## WALK-THROUGHS AND TESTS OF CONTROL

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Determining what to test is one of the key audit decisions related to the testing of controls. At this point, it is important to make a distinction between the documentation developed during the planning phase and concluded during the internal control phase and the controls the auditors decide to test.

In documenting and assessing the system of internal control, the auditor obtains and documents information on all significant activities and procedures and, in his or her evaluation, considers all controls. This is essential to obtaining an understanding of internal controls and the risk assessment process. In obtaining and documenting his or her understanding, the auditor will execute walk-throughs of all, or nearly all, activities and obtain documentation on forms used for inclusion in the audit working papers. During the documentation, the auditor typically examines a small number of transactions to document his or her performance of the walk-throughs.

In contrast, when controls are tested later, audit tests are usually limited to essential or key controls but require the review of a larger number of transactions. This is an important consideration in achieving audit efficiency. All too often, auditors have a tendency to test at the same level of detail as a walk-through, which not only increases their workload but may also detract from their ability to focus on issues of audit importance. How to determine what controls to test is discussed later in this chapter.

### **TESTS OF CONTROLS ARE NOT EFFECTIVE TESTS FOR TRANSACTION ACCURACY**

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A recurring misconception, particularly among inexperienced auditors, is that a direct verification of the accounting accuracy of a transaction is a test of controls. During a test of internal controls, the auditor is primarily testing compliance with controls, not verifying the accuracy of the transactions tested.

For example, in a test of controls over cash disbursements, an auditor typically examines documentation such as invoices to test compliance with internal controls. In these cases, the auditor may look for evidence that internal controls were followed in ordering the goods or services (e.g., a purchase order or similar documentation serving as an audit trail), that the invoice was approved for payment by an authorized individual, as required by the system design (audit trail documenting approval), and that the services or goods were received (audit trail documentation, such as a receiving report), among others. Compliance or noncompliance with these processes provides information on the extent to which controls are operational.

In addition, the auditor generally verifies attributes of the transaction itself, such as whether the amount of the disbursement equals the amount on the invoice (or whether a discrepancy is properly explained by the audit trail documentation) and whether the invoice was properly coded. In conducting these tests, the auditor determines whether the amount paid is correct (e.g., agrees with the invoice) and whether it was posted to the proper account (e.g., charged against the correct appropriation, element of expense account, properly capitalized if applicable, etc.). This is an important procedure because the auditor examines just a small fraction of all transactions and cannot afford to overlook any significant aspect of the transaction being tested. However, verifying this attribute is not a test of compliance with internal controls.

Even if the auditor finds no errors affecting accuracy or account classification, he or she cannot conclude by inference that controls promoting the correct payment and classification of expenses are operational. The controls could very well be working, and the accuracy of the transaction is indicative of this, but in these tests, the auditor was not testing any controls. Although reviewing the accuracy of the transaction is important, positive results do not directly support the auditor's prior assertion regarding internal controls. Conversely, if the auditor determines that an error has occurred, the error cannot be evaluated as another event of noncompliance. Audit judgment must be applied and the prior assessment of control risk (and the audit approach) revisited.

Tests of controls promote audit efficiency in part because the tests recognize that events of noncompliance will occur in even the best of systems supported by a strong control environment. As such, the auditor, using his or her judgment, identifies tolerable maximum noncompliance levels for controls. Thus, for example, the auditor may conclude that the universe of all transactions may include up to a 5 percent rate of noncompliance without forcing the reevaluation of the prior control risk assessment.

However, stating that a 5 percent noncompliance rate is tolerable is not the same as stating that the auditor is willing to accept that 5 percent of the transactions processed by the system are clerically inaccurate, inappropriate/fraudulent, posted to the wrong account, and/or improperly expensed or capitalized. Indeed, if the system produces data that can be up to 5 percent inaccurate, the data produced are very likely to exceed the materiality thresholds established by the auditor during the planning phase.

The reason that a 5 percent noncompliance rate may be tolerable but a similar clerical accuracy error rate is not is due to the objectives and assumptions behind testing internal controls. Stated simply, the fact that there was an event of noncompliance (e.g., no purchase order was issued or one was issued after the fact, the invoice was not matched against the receiving report, etc.) does not necessarily result in an error. Correct transactions can be processed (and often are) by weak systems of internal controls. In addition, in many instances, threats to the processes identified in the auditor's risk analysis (see discussion in Chapter 10) are totally or partially mitigated by more than one control. To the extent that other compensating controls were operational, the noncompliance event may not be significant. A clerical error or improper payment, however, has different implications, possibly including these:

- Internal controls are perfunctorily executed (e.g., invoices are signed and approved without appropriate review).
- The auditor has failed to identify all threats in his or her risk assessment.
- The auditor's assessment of the overall internal control environment was incorrect and needs to be downgraded.

At the outset of a test of internal controls, the auditor states what he or she considers to be a tolerable rate of noncompliance. The compliance benchmark may be expressed



statistically or judgmentally and may take the form of an absolute number of errors or a percentage rate using statistical techniques. At the end of the test, the auditor compares the actual results against the prior benchmark on compliance. If the benchmark is satisfactorily met (e.g., the error rate is below that which the auditor considered tolerable or acceptable), the auditor may reasonably conclude that the prior assessment of control risk was correct and proceed with the audit approach developed earlier, including, as appropriate, planned substantive testing. If the results are not within tolerable limits, the auditor must revisit his or her approach accordingly. Note that the auditor cannot ignore the implications of a transaction error (e.g., amount, legitimacy, posting) uncovered by a test of controls simply because the test results fall within a tolerable internal control compliance error rate.

## CONTROLS TO TEST AND HOW

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Factors to consider when deciding what controls to test include those listed next.

- *Importance.* A key consideration is how critical a control is. In practical terms, the more significant/imminent the threat a control mitigates, the more important the control.
- *Number of threats mitigated.* Testing a control that prevents or mitigates more than one threat can significantly increase audit efficiency.
- *Nature of the threat.* Just as one control may mitigate more than one threat, certain threats may be mitigated by more than one control. In general, the auditor may want to avoid testing controls that achieve the same objective. For significant threats, however, the auditor may want to test more than one mitigating control in order to add to his or her audit coverage and/or comfort level.
- *Verifiability.* In practical terms, to fulfill the auditor's purpose, a control must be verifiable. Disbursement approval, for example, is more easily verifiable if an audit trail (manual or electronic) is present. Without this trail, sampling is likely to be of little value, and observation may be the only option (but in this case, it may be of limited value to the audit). Faced with no audit trail, the auditor must seek alternative controls supported by appropriate audit trails or may be forced to drop the test of controls and execute extended substantive procedures with account balances.
- *Impact of information technology (IT).* Advances in IT often result in the loss of a visible audit trail or create other issues that the auditor must consider. For example, the transaction approval process may substitute passwords or encryption for a physical signature. Under these circumstances, the visible audit trail may consist of an indication in the transaction record or database that the transaction was approved at the proper level. Verifying that such a record exists is valid only if accompanied by audit testing procedures that verify controls over password access and encryption.

Selecting the controls to test along with the proper testing technique and approach requires the exercise of judgment and the application of common sense. Common pitfalls include:

- *Testing every aspect of the system and giving every control equal significance.* All too often, auditors test every aspect of a process, cycle, or system without considering the relationship between a specific procedure and a real threat. Thus, for example, in a poorly thought out test of payroll, the test of control may treat critical controls, such as controls over employee pay changes and adding new employees, as being of equal importance to lesser controls, such as controls over routine payroll forms, such as W-4s, insurance elections, contributions, and so on. (Remember, in the case of Federal audits, noncompliance with some of these lesser concerns may have to be reported as events of noncompliance with laws and regulations.)
- *Misinterpreting the purpose of a control.* The overabundance of internal control checklists often results in auditors memorizing controls (and incorporating them in their tests) without considering their real purpose. In an example that is more common in the private sector, a typical control is the requirement that disbursements over a certain amount require two signatures. This control is effective in preventing (barring collusion) authorized check signers from unilaterally defrauding their employer of significant amounts of money and is commonly found in most commercial entities. In the absence of check signature stamps (and most medium- and larger-size organizations use signature stamps), the dual-signature requirement can also be considered as a control promoting the use of extra care in approving larger expenditures of funds. However, as is usually the case, when a signature stamp affixes the double signature, the only purpose of the control is the prevention of fraud on the part of the authorized check signer. Further, the existence of a signature stamp raises control issues regarding the proper safeguarding of the stamp. In fact, if the stamp is not properly controlled, the presence of a signature stamp simply transfers the opportunity to commit fraud from a management-level employee to lower-level personnel (or, in the absence of proper access controls, to anyone in the organization). In spite of this discussion, many audit tests include testing for dual signatures while ignoring the security issues and the possibility of exploring a simpler verification procedure. Such a procedure might be confirming directly with a bank that dual signatures are required and that the bank (and not the auditee) is responsible for any potential loss for failing to comply with this requirement.
- *Overestimating the control's positive impact.* Time sheets are another example of a control commonly associated with low control risk and often indiscriminately included in a test of controls over payroll. Yet a time sheet that is not subject to external validation, such as a time clock (with controls preventing employees from

punching other employees' time sheets) or the signature of a properly motivated management-level employee cannot effectively ensure that employees are paid only for hours actually worked. Further, in the absence of gatekeeping controls over new employees, the time sheet accomplishes little in preventing the presence of phantom employees.

- *Underestimating operating management monitoring controls.* Auditors often view sampling (discussed later in this chapter) as the only effective means of obtaining competent evidential matter. This bias is often at the expense of testing other potentially strong controls, such as management's monitoring of its operations. Without denying or mitigating the critical importance of sampling in auditing, the auditor should be aware of the importance of monitoring controls in reducing control risk and the potential impact the testing of monitoring controls may have on the audit's efficiency. Monitoring controls also includes observation by both management and executives at all levels of operation as well as by an independent function, such as an internal audit function. While the auditor seldom underestimates the usefulness of an effective, truly independent internal audit function, the same is not the case in connection with operating management's own monitoring activities. Yet monitoring activities by knowledgeable personnel who are held accountable for results (particularly if the financial records are part of the measuring criteria) significantly impact a system's ability to produce accurate financial data. It should be easy to see that the presence of operating personnel with a vested interest in how financial results are recorded provides great assurance that financial transactions are charged to the proper appropriation, organization, program, or activity and that all charges are legitimate. Further, monitoring is an activity that can be tested with sufficient objectivity through inquiry, observation, and inspection of records (although, admittedly, certain aspects of the test are, of necessity, more subjective than in audit sampling). Finally, the all-encompassing nature of the Federal budget and the clear priority assigned to it by the Constitution and other laws of the land, politicians, Federal executives, oversight agencies, and the American public ensure the presence (albeit not necessarily the effectiveness) of a monitoring function at all levels of the Federal Government.

Once the auditor decides what controls to test and, ideally, has avoided the potential pitfalls discussed earlier, he or she proceeds with the execution of the different tests of internal controls. Later sections in this chapter discuss the most common form of testing—audit sampling—and other types of tests auditors consider in validating (or disproving) the prior assessment of control risk.

In general, tests of controls provide indirect evidence on the accuracy of account balances by testing whether the systems, processes, and cycles affecting an account are supported by an appropriate internal control design, which operates effectively in

accordance with the design. If the controls are appropriate and operating effectively, the auditor concludes that the systems/processes/cycles affecting a particular account can be relied on to produce account balances that are fairly stated in all material respects in accordance with generally accepted accounting principles (GAAP).

## SUBSTANTIVE TESTS

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Substantive tests typically are performed in combination with tests of controls to provide additional support for specific audit assertions. Although auditors are allowed to perform substantive tests only, they still must obtain the necessary evidence to ensure that they have properly understood the system of internal controls and that the execution of substantive procedures decreases the audit detection risk to an acceptable level.

Substantive testing provides direct evidence on an account balance regardless of the systems and/or controls interfacing with the account. *Substantive testing* may be defined as audit procedures designed to detect material misstatements at the assertion level. The AICPA has classified substantive audit tests into two groups (AU-C 330.04):

1. *Test of details*. Classes of transactions, account balances, and disclosures
2. *Analytical procedures*. Evaluation of financial information through analysis of plausible relationships among both financial and nonfinancial data

Substantive testing does not ignore the results of tests of internal controls. In fact, the extent and nature of substantive testing is usually dictated by the auditor's internal control evaluations and, when applicable, testing results.

The extent of substantive testing will, in most instances, be determined by these factors (or combinations thereof):

- The auditor's evaluation of internal controls. In general, the extent of testing is directly related to the auditor's final determination of audit risk on completion of audit testing (if audit testing was deemed appropriate). The need for substantive testing decreases as the auditor's confidence with and reliance on internal control increases.
- The specific weaknesses in internal controls identified during evaluation and/or testing.
- Audit efficiency when the auditor determines that substantive tests will require a lower level of effort than a test of internal controls, regardless of the auditor's risk assessment (but see the next requirement).
- The OMB requirement that internal controls be tested when the auditor concludes that an effective internal control design is in place. If the auditor must comply with this OMB requirement even though a substantive test may be more efficient, he or she usually will develop a hybrid test combining substantive procedures with internal control testing.

AICPA guidance (AU-C 330.18) actually requires the execution of substantive procedures “for all relevant assertions related to each material class of transactions, account balance, and disclosure.” The guidance goes on to explain that this is a necessary check on the judgmental nature of the auditor’s evaluation of internal control.

In addition, AU-C 330.21 requires these specific substantive audit procedures:

- Agreeing or reconciling the financials and notes to the underlying accounting records (e.g., tie balances to the GL).
- Examining material journal entries and adjustments made during the financial statement preparation process.

Readers may note the use of the word *should* as opposed to *must* in regard to these requirements. We again suggest that most, if not all, *shoulds* be treated as *musts*. If nothing else, the requirements just listed are simply commonsense ones.

### **Validating Account Balances**

Auditing the existence of account balances can be accomplished directly by examining the documentation or other physical evidence substantiating the validity of the GL balance. Typical procedures are listed next.

- Testing a sample of transactions posted to the account throughout the year or period under audit. (Audit sampling is discussed later in this chapter.) This typically includes the examination of documents supporting the transaction (e.g., invoices). As a general rule, the auditor:
  - Concentrates on large transactions to, in effect, “audit” a sufficient percentage of the total account balance.
  - Reviews the file for unusual transactions.
  - Develops projections from sampling results usually applying statistical techniques.
  - Employs a combination of these procedures.
- Physically inspecting the account components (e.g., physical inventory observations; verification of the physical existence of property, such as buildings).
- Directly confirming account components (usually in connection with accounts receivable but may also be used in connection with inventories held by a third party and with accounts payable).
- Reviewing and verifying account reconciliations including reconciliation of:
  - Fund balance with Treasury (or cash held outside Treasury).
  - Detailed subsidiary ledgers (e.g., accounts receivable or payables) to the GL’s control account.
  - Property records kept by a custodian function (e.g., perpetual inventory records and property, plant, and equipment records) to the GL control account.

- Physical inventory counts to the GL control account.
- Recomputing auditee estimates and other auditee-developed data to verify accuracy of estimate or computation (e.g., footing auditee prepared analysis, recomputing auditee's accruals).

### Analytical Procedures

In general, analytical procedures compare different but related sets of financial data to assess whether the relationships and variances between the data are consistent with the auditor's expectations. Typical relationships that auditors consider are listed next.

- *Comparing prior-year account balances to current-year balances.* In this procedure, the auditor looks for unusual variances in account balances from one year to the next. Unusual variances generally consist of significant increases or decreases that cannot be explained by other known variables (e.g., increases or decreases in programs and activities, new programs, program terminations, etc.). However, the auditor must consider that the lack of an increase or decrease in an account may also constitute an unusual variance. This would be the case, for example, if a program is terminated but accounts related to the program remain unchanged from the prior year.
- *Considering the consistency of financial ratios.* In this procedure, the auditor considers whether relationships, such as the relationship between the agency's budgetary and proprietary accounts, revenues to accounts receivable, expenses to accounts payable, and so on, are consistent with the entity's historical ratios. This is an important procedure because, for example, a decrease in the ratio of revenues to accounts receivable may be indicative of a deteriorating receivable. Similarly, if a working capital fund shows a decrease in the ratio of sales to inventory (inventory turn ratio), this condition may be indicative of obsolete or damaged inventory.
- *Performing rough tests of account balances.* Under this procedure, the auditor develops a simple estimate of what an account value should be and compares this value with the actual account balance. A typical example consists of developing an estimate of accrued salaries based on the last pay period of the year and comparing this estimate to the agency's recorded accrued salaries.
- *Projecting/estimating account balances.* This procedure is similar to developing rough tests of account balances (just mentioned). However, projections and estimates are usually more complex and often make use of statistical procedures, including regression analysis, to project/estimate account balances. Typical applications include:
  - *Estimates for uncollectible receivables.* This may include, for example, considering the aging of accounts receivable and developing a relationship (statistical or judgmental) between the aging and future write-offs to generate an estimate of uncollectible receivables.

- *Grant accrual estimates.* A significant number of Federal Agencies are involved in the issuance of grants to individuals, institutions, and state and local agencies. For these agencies, the year-end grant accrual is material to the agency's financial statements. Given the current tight deadlines for the issuance of Federal financial statements, auditors cannot rely on more traditional procedures (e.g., review of grant activity/payments after year-end) and must rely on projections (statistical or judgmental) to validate the reasonableness of the grant accrual.
- *Year-end liability estimates.* Before closing its books, each Federal Agency must consider outstanding debts and develop a reasonable estimate of the liability for services or goods received that have not been invoiced by vendors (or that have not yet been entered into the appropriate accounting system). In the past, the traditional audit procedure consisted of performing a test for unrecorded liabilities where the auditor examined postclosing disbursement/invoice vouchering activity for a number of months subsequent to year-end to test the reasonableness of the year-end estimate. As was the case with grants, the shortened reporting deadlines typically require the execution of analytical procedures to test/validate the reasonableness of the year-end balance for accounts payable.

Analytical procedures are not limited to the testing phase. In fact, as noted, AICPA guidance (AU-C 315.06) requires that the auditor use analytical procedures in planning and performing risk assessment procedures. It should be clear that procedures such as comparing balances from year to year and assessing the implications of financial ratios would quickly identify areas of potential audit significance that should be considered during the planning phase and in the development/revision of audit programs.

The execution of analytical procedures in connection with substantive procedures is left to the auditor's judgment. However, analytical procedures are often nonlaborious, time-saving procedures that can significantly increase the auditor's efficiency. Moreover, it should be apparent that the complexity and size of Federal Agencies, coupled with ever-tightening reporting deadlines, leave the auditor with no option but to make use of these techniques. AICPA guidance requires that when the analytical procedure is a significant substantive test, the expectations, results, and additional related procedures performed be documented.

Related procedures usually include inquiries of the auditee (e.g., to explain unusual variances) and limited tests of accounting data. It is important that the auditor independently test information provided by the auditee and that he or she ensures the integrity and completeness of the universe from which accounting data are selected for testing. (The importance of ensuring data integrity and completeness is discussed in more detail later in this chapter.)

## AUDIT SAMPLING

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Sampling is a common audit procedure. The AICPA defines sampling as the execution of audit procedures to less than 100 percent of the items in the universe or account being audited (AU-C 530). At the outset, it should be understood that sampling encompasses judgmental, nonrandom procedures as well as statistical sampling. In practice, the auditor often combines judgment and statistics in the execution of sampling-related procedures. This section discusses sampling as it relates to both tests of controls and substantive testing, goes over some dos and don'ts in the use of sampling, and concludes with a summary discussion of statistical sampling.

### **Sampling Applications**

Sampling can be used in connection with the two types of audit tests discussed earlier. Sampling in connection with tests of controls and substantive tests differ in terms of the information that the auditor examines in the execution of his or her test.

### ***Controls Testing***

In the execution of tests of controls, the auditor looks for evidence that a control was complied with. For example, the auditor looks at supporting documentation, such as receiving reports, invoices, purchase orders, and management approvals, to verify that goods and services were ordered and approved in accordance with the procedures and controls that were previously considered in the determination of control risk. Similarly, the auditor may look for approved time sheets and approved payroll registers (or evidence that the register was reviewed by management) to test key controls identified in the evaluation of the payroll cycle.

### ***Substantive Testing***

In the execution of substantive procedures, the auditor is concerned with the accuracy of the account balance, not with the controls present in the processes/cycles that created the account balance. Again, the auditor looks at supporting documentation. However, in substantive testing, he or she is interested in establishing the accuracy of the transaction recorded in the account. Thus, the auditor may look at a vendor invoice to ensure that the account is properly valued or at a sales invoice to support an individual balance in accounts receivable.

## SAMPLING CONSIDERATIONS

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This section expands on some key issues that the auditor should consider when using sampling techniques.



### Ensure Completeness of the Universe

The purpose of the sample is to make an assertion on the population being tested, such as whether internal controls are operational (in a test of controls) or whether account balances are fairly stated (in a substantive test). These assertions are the result of the auditor's examination of a (usually) small percentage of the population. Therefore, it is essential that the auditor ensure that the universe being audited includes all the transactions processed by the cycle or affecting an account balance for the period covered by the test.

Prior to selecting a sample, the auditor obtains a record or database of all appropriate elements of the universe to be sampled. In general, the universe consists of:

- *Test of controls.* In the test of controls, the universe under audit typically includes all transactions processed by the cycle or system of internal controls, such as all cash disbursements, all cash receipts, all payroll checks, and so on, for the period tested.
- *Substantive test.* In a substantive test of an account balance, the universe is usually defined in terms of specific items, such as individual accounts receivable or payable, properties, inventory items, and the like that make up the account balance at the end of the year (or interim period under audit). The universe can also be defined in terms of all transactions that affected the account during the period under audit (e.g., beginning balance plus all debits and credits affecting the account). While this latter approach may be appropriate under certain circumstances (e.g., in the audit of property, plant, and equipment where the beginning balance was previously audited), defining the universe in terms of the specific items making up the account balance is often preferable (e.g., list of vendor amounts included in an accounts payable balance).

The auditor is ultimately interested in being able to issue an opinion on the financial statements. The financial statements are derived from the books and records of the auditee (typically, the GL plus year-end adjustments). Therefore, to ensure the completeness of the universe, the auditor must ensure that the universe was, in fact, derived from the GL (including adjustments, if applicable).

In the case of an account balance audit, this procedure is relatively simple. The auditor adds the schedule of all items making up the balance (e.g., all accounts receivable) and verifies that the sum of these items agrees with the GL balance (including year-end adjustments, if applicable).

Under certain circumstances, reconciling the database to the accounting records in a test of controls may be rather straightforward. For example, in the case of a payroll test, the auditor may be able to exactly match the total of the universe tested to a payroll expense account in the GL. Similarly, if the audit consists of testing benefit payments (e.g., in connection with the audit of an insurance or social benefit fund), the auditor may be able to relate the sum of these payments to a benefit expense account.

In practical terms, however, validating the universe in a test of internal controls is not a straightforward procedure. Even in the simplified examples given, the auditor is likely to encounter difficulties in reconciling his or her database to the accounting records since it is almost certain that the payroll expense account and the benefit expense account, as well as the cash accounts, will include other transactions (e.g., journal entries, adjustments, accruals, etc.). Although validating the universe is not always a simple procedure, if the auditor has obtained a sound understanding of the accounting cycles and processes during the planning and internal control phases, he or she will be able to efficiently relate the universe being tested to the books of original entry.

The failure to validate the completeness of the universe being tested is a recurring problem with the quality of Federal audits. Indeed, the authors of this book, on more than one occasion, have encountered situations where large samples were selected to test a critical process but the database from which the sample was selected was never agreed to the accounting records. Moreover, some of the recent auditing failures can be related, at least in part, to a failure to ensure the completeness of the universe. Selecting a sample without validating the universe from which it is selected renders the audit test meaningless.

### **Analyze the Universe**

IT provides the auditor with ample opportunity to increase audit efficiency and ensure that the audit focuses on areas of potential audit significance. In most Federal audits, the universe from which the sample is to be selected consists of an electronic file or database, ideally including all of the elements to be tested.

Electronic files provide the auditor with the opportunity to analyze the characteristics of the universe and, in certain cases, even “audit” 100 percent of certain attributes. Typical procedures that can be performed to increase audit efficiency are listed next.

- *Obtain a frequency distribution of the file.* In testing disbursements of any kind (e.g., benefits, grants, payroll, vendors), a frequency distribution provides numerous opportunities to improve audit efficiency.
  - *Identify large payments.* This procedure allows the auditor to concentrate on large payments (thus increasing audit coverage) and/or to identify unusual payments for follow-up.
  - *Increase the efficiency of statistical applications.* Stratification of the universe often increases audit efficiency by reducing the impact of the variability of the population on the sample size.
  - *Support the execution of analytical procedures.* For example, comparing the current year’s frequency distribution to that of a prior year’s may uncover unusual trends that could merit audit consideration.
- *Execute file matches.* It may be possible to test 100 percent of attributes by executing file matches. For example:

- In a test of benefit payments, it is possible to match payments to beneficiaries with the Social Security Administration's files to ensure that benefit checks do not continue to be issued after a beneficiary's death.
- A match of this year's file to the prior year's can identify new payees and enable auditors to test gatekeeping controls.
- *Support exception testing.* The auditor may be interested in testing payments based on certain attributes in the file. In addition to large payments, the auditor may be looking for other characteristics, including, for example, all disbursements:
  - Charged to a specific element of expense account (e.g., all payments charged to a maintenance account or property, plant, and equipment to test for incorrect classifications).
  - To a particular payee (e.g., to test for reimbursable travel expenses and/or advances to executives and other members of management).

In summary, databases and files provide the auditor with significant sampling opportunities to increase audit efficiency and properly focus the audit effort.

### **Relationship of Control Testing to Substantive Testing**

An effective audit approach relates substantive testing to internal control testing. Substantive testing cannot take place in a vacuum. Substantive testing is derived entirely from the auditor's evaluation of internal control. Auditors perform substantive testing for a variety of reasons, but the extent of substantive tests is always dependent on the state of an entity's internal controls. Weak or ineffective controls all result in the need to do more extensive and possibly different substantive tests, including a controls environment that:

- Lacks effective internal controls (either due to flaws in the design or to non-compliance, as noted during internal control testing).
- Requires that the auditor compensate for certain weaknesses in internal controls.
- Mandates the auditor provide additional audit coverage on the large account balances.

Notwithstanding the design of an efficient audit approach and lack of effective controls, for all significant systems, the auditor must perform sufficient control tests to comply with OMB's Federal audit guidance.

Assuming that the auditor properly performed the risk assessment during the prior phase of the audit, the verification procedures encompassed by substantive testing will ensure that the audit effort focuses on aspects of the account balance that are at risk of being misstated.

It would be erroneous to conclude that substantive testing results never have an impact on the auditor's evaluation of internal control. As noted earlier, planning and reevaluating the audit approach are never-ending aspects of every audit. Thus, substantive testing often

provides additional information on internal controls that the auditor must take into account. Results and related actions that the auditor considers include:

- *Adverse results.* The execution of substantive procedures may disclose significant errors that will require audit adjustments. Depending on the prior assessment of control risk as high, moderate, or low (following *Financial Audit Manual [FAM]* terminology), the auditor will:
  - If control risk was evaluated as high, consider whether the substantive procedures in the audit approach are sufficient to ensure that all material errors will be identified and corrected. Careful audit judgment must be exercised to ensure that conditions anticipated during the earlier evaluation are no worse than expected. If the auditor's worst expectations are exceeded, he or she must reconsider whether substantive procedures can overcome the risk that accounts are not fairly stated. Further, it is important to note that there are cases where the exclusive use of substantive procedures will not provide sufficient audit evidence to support the auditor's assertions.
  - If control risk was evaluated as moderate or low, consider whether errors disclosed by the procedures force the auditor to revise his or her evaluation of internal controls. In turn, this reevaluation often results in additional substantive testing or, if the results are adverse enough, a reconsideration of whether substantive procedures can overcome the risk that accounts are not fairly stated.
- *Positive results.* It is possible that substantive procedures disclose fewer errors than anticipated (or even no errors) based on the auditor's risk assessment. The auditor could, of course, ignore the positive results without increasing his or her audit risk (e.g., conclude that the account is fairly stated when, in fact, it is not). However, a careful evaluation of the results may lead the auditor to discover the presence or effectiveness of a control that was missed or not properly considered in the evaluation of internal controls. If this were the case, the auditor would be in a position to revise his or her audit approach. Although it is unlikely that this finding will increase the efficiency of the current year's audit, it may favorably impact the auditor's efficiency in future audits. Additionally, it may impact the nature and extent of required communications with management and/or those in governance.

### Statistical Sampling

Statistical techniques and statistical sampling are usually essential to the execution of an efficient audit strategy. Statistical sampling has the advantage of producing measurable results and, in many cases, achieves audit objectives with a relatively small sample size. This section summarizes some key aspects of statistical sampling in auditing, but a full discussion of statistical sampling is beyond the scope of this book. There are a number of very helpful documents in this area that the reader may wish to consult, particularly:

- GAO's *Using Statistical Sampling* (May 1992 revision). A very helpful how-to document with insightful discussions on attribute sampling and variables estimation procedures
- AICPA's audit guide titled *Audit Sampling* (June 22, 2012 edition). Provides helpful guidance on statistical sampling including a very valuable discussion on the use of probability proportional to size sampling

The successful application of statistical sampling in an audit requires the careful identification, definition, and evaluation of a number of variables. A discussion of some of these variables follows.

- *Population*. The universe of items from which a sample is taken (e.g., all disbursements, all receipts, all payroll payments).
- *Sampling unit*. Any of the individual items encompassed by the population (e.g., a check, a deposit, an invoice). In defining the sampling unit, the auditor must consider the attributes to be tested or account balance to be estimated as well as the ease with which a sample can be selected.
- *Error*. In attribute testing, an event of noncompliance with internal controls and/or clerical errors uncovered by testing procedures.
- *Sampling risk*. Relates to the possibility that the test includes a sample that will lead the auditor to reach an incorrect decision regarding the characteristics of the universe. In statistical sampling, risk can be expressed as incorrectly concluding that the controls tested are:
  - Being followed or complied with or that the account balance is not materially misstated. This risk may result from the auditor issuing an unqualified opinion when, in fact, such an opinion is not warranted.
  - Not being followed or complied with or that the account balance is materially misstated. In internal control testing, this may lead the auditor to perform additional substantive procedures, thus needlessly decreasing audit efficiency but not affecting the audit assertion (e.g., the auditor is guilty of overauditing but not of reaching the wrong conclusion and/or type of opinion). However, in substantive testing, this type of error may lead the auditor to propose an audit adjustment that materially misstates the account balance under audit.

Statistical sampling supports both test of controls and substantive tests. Types of tests or approaches typically used in auditing include:

- *Attribute sampling*. Attribute sampling is most commonly used in tests of controls and tests of compliance with laws and regulations. Under attribute sampling, each unit tested will have one of two mutually exclusive characteristics (e.g., the control was complied with, or the control was not complied with). This procedure allows the auditor to develop an estimate of the universe's error rate (e.g., the extent to

which a control is not being complied with expressed as a percentage of the total population). In this type of test, the auditor is concerned with the maximum error rate of the population (at a given confidence level). If the maximum error rate is within a predetermined compliance range (e.g., no more than 5 percent), the auditor generally concludes that controls are effective. If the error rate is higher than the tolerable limit, then the auditor revises the risk assessment and modifies the audit approach, as necessary.

- *Variable estimation sampling.* This sampling develops a projection within which the true audited value of the population lies. In this type of test, the auditor determines a true or audited value for an item in the population (e.g., an invoice or a check) and from the audited value generates an estimate of the total population. The auditor compares the estimate with the actual account balance, and, assuming the desired sampling precision was met, the auditor either concludes that the account balance is fairly stated or proposes an audit adjustment to correct the balance. Audited value relates to the correct amount of the sample item (e.g., a recorded invoice, check, individual account receivable or payable, etc.) regardless of the value at which it was recorded by the accounting cycle. Thus, the audited value can differ from the value recorded in the books and records of the auditee (i.e., because the transaction was incorrectly recorded).

Variable estimation sampling encompasses direct, difference, and ratio estimations. Direct estimation consists of developing a projection of an account balance by utilizing the true or audited value of the sample items (e.g., an estimate of total accounts receivable from the audited value of all accounts receivable selected in the sample). A major problem with direct estimation is that obtaining the required precision for the estimate to be within tolerable limits often requires very large sample sizes. This problem can be overcome by the application of difference and/or ratio estimation techniques. Difference estimation consists of developing an estimate of the account balance by taking into account the difference between audited and recorded or book value. Ratio estimation develops the estimate based on the ratio of the audited value to the recorded value. In both cases, the approach is likely to significantly reduce the size of the sample required to develop projections that fall within tolerable limits.

Although difference and ratio estimation techniques can significantly increase the precision of the estimate, they should not be used unless a minimum number of errors are included in the randomly selected sample. (GAO recommends a minimum of 10 errors and notes that some statisticians believe the number should be as high as 30 errors.)

- *Probability proportional to size sampling (PPS).* This method combines characteristics of both attribute sampling and variable sampling. This approach is also known as dollar unit sampling because in PPS, the sampling unit is each dollar included in the

population or account. That is, each dollar in an account has an equal chance of being included in the sample (thus providing higher-value items/transactions with a proportionately greater chance of being selected). PPS allows the auditor to combine an attribute sampling approach with the ability to develop dollar projections. This approach is more informative than attribute sampling because it expresses results in terms of dollars. In addition, PPS is easier to apply than variable estimation sampling and typically requires a smaller sample size. As a result, PPS is, at least arguably, rapidly becoming the most often used statistical technique in auditing.

## INFORMATION TECHNOLOGY CONSIDERATIONS

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IT alters the fundamental manner by which transactional data are initiated, input, recorded, compiled, classified, and ultimately reported. IT-driven systems paper trails common to most manual systems disappear to support enhanced economy and efficiency, the duties and responsibilities of computer-based systems personnel are different, and maximum segregation of duties of the old systems may no longer exist or be relevant. It is important to heed the AICPA's guidance with respect to technology and computerized data processing systems.

- IT provides the potential benefits of effectiveness and efficiency for an entity's internal control because the technology enables an entity to:
  - Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data.
  - Enhance the timeliness, availability, and accuracy of information.
  - Facilitate the additional analysis of information.
  - Enhance the ability to monitor the performance of the entity's activities and its policies and procedures.
  - Reduce the risk that controls will be circumvented.
  - Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems (AU-C 315.A56).
- IT also poses specific risks to an entity's internal controls, including:
  - Reliance on systems or programs that are processing data inaccurately, processing inaccurate data, or both.
  - Unauthorized access to data that may result in the destruction of data, or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions.
  - Unauthorized changes to data in master files.
  - Unauthorized changes to systems or programs.
  - Failure to make necessary changes to systems or programs.

- Inappropriate manual intervention.
- Potential loss of data (AU-C 315.A57).
- The extent and nature of these internal control risks vary depending on the characteristics of the entity's information systems. For example, multiple users, either external or internal, may access a common database of information that affects financial reporting. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data. When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This could result in unauthorized transactions or changes to programs or data that affect the financial statements. Therefore, the nature and characteristics of an entity's use of IT in its information system affect the entity's internal control (AU-C 315.A60).

## **OUTSOURCING ACCOUNTING AND DATA SERVICES**

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Outsourcing of data services does not eliminate but rather aggravates the data control risks by fundamentally altering the approach to testing and validating the data processes of an agency.

Whether data are processed, accounted for, and reported by a manual system, an in-house computer processing facility, or outsourced in whole or in part to an external provider of these services, the fundamental control issues and the responsibilities of the auditor do not change. Under each scenario, the auditor is required to gain an understanding of each of the components of an agency's internal control structure (i.e., the controls environment; the agency's regular risk assessments; the control activities, policies, and procedures for implementing management directives; the supportive information and communication systems for identifying, capturing, and reporting; and the monitoring process to assess the quality of controls).

When data services have been outsourced, the servicing entity could be responsible, under the outsourcing contract, for part or all of the original systems design and software as well as data input, processing, and reporting. Under these conditions, the outsourcing Federal Agency has limited or no management control over the data being processed/generated, yet the quality of services provided by the servicing entity become controls and systems considerations for the auditor. The AICPA suggests that information concerning the servicing organization controls and systems be examined, tested, and validated from a wide variety of sources, including:

- The servicing organization's user manuals.
- Systems documentation, technical manuals.



- The terms, conditions, and scope of services of the outsourcing contract.
- Reports issued by the servicing organization's independent auditor, internal auditor, and retained consultants.
- Reports of regulatory agencies.

A specific section of the AICPA's Professional Standards (AU-C 402, *Service Organizations*) provides considerable guidance on addressing the control risks associated with data processing, accounting, and reporting that have been outsourced to an organization external to the audited agency. Over the years, an increased use of service organizations has caused the AICPA to issue several related statements on auditing standards (SAS). The latest such issuance currently in effect is Statements on Standards for Attestation Engagements (SSAE) 16, *Reporting on Controls at a Service Organization*.



# 12 END-OF-AUDIT, QUALITY CONTROL, AND REPORTING PROCEDURES

The reporting phase, Phase IV, will, of course, culminate with the issuance of the auditor's reports; however, prior to the issuance of the reports a significant number of procedures requiring the involvement of the more senior members of the audit team will take place. During this phase, the auditor:

1. Obtains legal and management representation letters.
2. Performs a final evaluation of audit results, including waived adjustments, and determines the types of audit assertions that the audit results support.
3. Concludes quality review procedures (including a technical review by an independent senior-level member of the audit organization, such as a partner or equivalent, if a government audit team performs the audit).
4. Issues draft and final reports.

## **OBTAIN MANAGEMENT AND LEGAL REPRESENTATION LETTERS**

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### **Management Representation Letter(s)**

Guidance from the American Institute of Certified Public Accountants (AICPA) AU-C 580 requires auditors to obtain management representations on all audit engagements.<sup>1</sup> Office of Management and Budget (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements*, and the Government Accountability Office (GAO) *Financial Audit Manual (FAM)* adopt this guidance and require that the letter, at a minimum, address:

- Financial statements (acknowledging management's responsibility for the statements and asserting that the statements were prepared in accordance with generally accepted accounting principles [GAAP]).
- Effectiveness of internal control and significant deficiencies identified.
- Compliance with Federal financial management system requirements.
- Compliance with laws and regulations.

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<sup>1</sup> The AICPA is currently engaged in a clarification and recodification effort that will replace the current AUs. The term AU-C refers to section numbers that have replaced AUs. Once this effort is completed (anticipated for 2014), all references will revert back to AU.

More specific topics generally addressed by the letter include these:

- Whether all pertinent financial records and data were made available to the auditor
- Whether all relevant data have been disclosed in the financial statements
- Management's responsibility for internal controls, including fraud prevention controls
- Cases of known, suspected, and/or alleged fraud
- Related party transactions
- Accuracy of estimates
- Contingencies
- Management plans that may affect the value of the entity's assets and/or liabilities

The required representations just listed, especially for large entities, may be made using a materiality threshold. The auditor should discuss and reach an understanding of this threshold with management. Ultimately, the threshold should be disclosed in the letter and would clearly state that items below the threshold are not reported. Generally, the materiality threshold should be set at a level significantly below design materiality to ensure that many items below this level would not aggregate to a more significant amount. When the management representation letter does not disclose a threshold, management should note all relevant matters in the letter, regardless of significance.

A management representation letter is not a substitute for audit procedures, and it is presumed that, with the exception of very subjective information, such as management's future plans, the auditor has independently verified all significant assertions made by management. However, a management representation letter provides the auditor with a useful vehicle for addressing significant accounting and auditing issues by requiring management to state in writing its understanding and position on the issue, thus ensuring that auditee and auditor share the same understanding of complex issues. In addition to the required contents just listed, the auditor should consider tailoring additional representations to the specific circumstances of the auditee.

Under AICPA guidance, referenced by OMB Bulletin 07-04, the management representation letter is an important audit procedure. Management's refusal to provide these written representations would be a limitation to the scope of the audit, sufficient to preclude issuance of an unmodified (also referred to as unqualified) audit opinion and ordinarily sufficient to cause the auditor to disclaim an audit opinion or withdraw from the engagement (AU-C 580.25). In the face of this type of refusal, an auditor may wish to reconsider whether to be associated with the auditee at all, according to the AICPA.

The letter is typically signed by relevant officials who are knowledgeable and responsible for the matters noted in the letter. This often includes the chief executive of the auditee and the chief financial officer (CFO). As a matter of practice, other individuals in a position to influence financial data, such as a chief accountant or controller, should also be considered. Finally, the auditor may wish to obtain specific representations from other

management personnel (e.g., representation by a program manager on certain aspects of a major program for which he or she is responsible). The letter should cover all periods reported on and should be dated as of the date of the auditor's report to ensure the representation covers the entire period for which the auditor is responsible. The representation letter should be received after the legal representation letter, discussed next. Additionally, OMB and GAO guidance requires the auditor's summary of unadjusted misstatements to be attached to the signed management representation letter.

### **Legal Representation Letter(s)**

Legal representation letters are governed by AICPA guidance (AU-C 501), OMB Bulletin 07-04, GAO *FAM*, and guidance from the Department of Justice. The purpose of the legal letter is to obtain information on active and/or potential litigation that may have an impact on the financial statements. According to the AICPA guidance, a lawyer's refusal to furnish the requested information, either in writing or orally, would be a limitation on the scope of the audit sufficient to preclude issuance of an unmodified audit opinion. As a general rule, the auditor will request such information from the agency's general counsel. The AICPA states that evidence obtained from inside counsel is not a substitute for information that outside counsel refuses to furnish. However, the auditor should also consider whether outside legal counsel (including the Department of Justice) has been involved in litigation and, as necessary, obtain legal letters from them.

It is important to note that the auditee's management is the primary source of information on legal matters. The legal letter provides independent evidence on the validity of management's assertion. Legal letters are requested by appropriate auditee personnel (e.g., the CFO) and instruct the attorney to respond directly to the auditor (with a copy to the individual making the request). In general, the letter will request information on litigation, claims, and assessments that exceed specific amounts based on the auditor's assessment of materiality and as agreed with the auditee. Legal letter content typically includes these items:

- Pending or threatened litigation
- Unasserted claims and assessments
- An evaluation of the two items just listed and likely outcome, including estimates (if possible)
- An acknowledgment from the attorney of his or her professional responsibility to disclose to the auditor matters that in his or her opinion require disclosure
- A listing of cases that have required substantial attention by the attorney
- The nature and reasons for limitations (if any) placed by the attorney on his or her representations

OMB Bulletin 07-04 and the GAO *FAM* provide a detailed illustration of the letter requesting a response from the attorneys. Because of the technical nature of the letter, the auditor is well advised to encourage the agency to follow the bulletin's format as closely as

possible. As a practical matter, the auditor often drafts the legal letter request for the auditee's signature. Timing of the letter is critical to ensure that the date is within two weeks of the end of fieldwork and that it is received with sufficient time to meet the reporting deadlines of the auditee's and the U.S. Government financial statements. Finally, the auditor should consider corroborating the responses received from legal counsel through inquiry and other procedures.

The GAO *FAM* provides an example summary schedule that agencies are encouraged to use to summarize the case-specific details provided in the legal representation letter. Specifically, the likelihood of unfavorable outcome and the estimated range of potential loss is summarized in order to determine which contingencies may need to be accrued in the financial statements and which may need to be described in a note disclosure to those statements.

### **FINAL CRITIQUE OF AUDIT PLAN, PROGRAMS, AND PROCEDURES**

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Assuming that testing proceeded as expected (e.g., tests of controls supported the effective operation of internal controls and substantive testing resulted in no significant findings or adjustments), the auditor can conclude that the audit results support the issuance of an unmodified opinion.

In short, the audit process requires the auditor to continually reassess his or her approach and develop additional and/or alternate procedures to compensate for audit findings, audit obstacles, and other peculiar or unanticipated conditions or circumstances that were encountered in relation to the specific auditee. Given the dynamic nature of the process, it is essential that at the conclusion of testing, senior members of the audit team carefully consider the implications of the audit findings and whether the audit effort resulted in sufficient audit coverage to warrant the expression of an audit opinion, as well as what type of opinion can be issued.

In determining the sufficiency of audit coverage, the auditor will consider quantifiable findings as well as more subjective issues including financial statement exposures, accounting issues, and scope limitations (including incomplete data and limitations imposed by national security requirements).

To the extent that there is agreement with the auditee on audit adjustments and materiality, recording (or waiving, if not material) audit adjustments is a relatively straightforward process, requiring only that the auditor verify that adjustments are properly reflected in the financial statements.

Subjective issues, however, require the exercise of audit judgment in, for example, determining the reasonableness and support for estimates and contingencies (including the likelihood of occurrence in the case of contingencies), deciding on a preferred accounting principle, or considering the implications of scope limitations.

There is no simple answer or checklist approach to deal with issues that require the exercise of audit judgment. What is clear, however, is that these matters need to be properly documented in the work papers. As a practical matter, the auditor generally

documents this effort in written memoranda that describe the important audit and accounting issues encountered and the rationale behind his or her decisions. Thus, the auditor's conclusions regarding estimates and contingencies should carefully document all sources of information consulted and leading to his or her conclusion. Decisions regarding a choice of accounting principles should clearly identify the authoritative guidance researched by the auditor as well as the alternatives considered.

Finally, scope limitations must be considered in light of their nature. Limitations imposed by national security requirements usually need be analyzed only in light of the materiality of the specific account that is affected. Limitations imposed by incomplete data (e.g., missing documentation) raise significant doubts regarding the effectiveness of internal controls and the internal control environment. Here the auditor must consider whether sufficient additional procedures were performed to overcome this situation, or whether the deficiency is significant enough to force a qualification or disclaimer of the auditor's opinion due to the lack of documentation. Finally, scope limitations that appear to be capricious in nature (e.g., an auditee's refusal to provide access to certain information or to provide requested written representations) are particularly troublesome and may force the auditor to disclaim an opinion or even to refuse to be involved with the audit.

### **Clean Opinion Not Guaranteed**

Although the auditor cannot guarantee the issuance of a clean opinion, he or she has a professional responsibility to use best efforts to develop an audit approach capable of compensating for existing audit obstacles. Where the auditor is unable to develop such an audit approach, he or she should provide recommendations that will enable the auditee to effectively address audit obstacles and issues to enable the issuance of an unmodified opinion in future years.

In performing the final end-of-audit evaluation of audit coverage, the auditor is also responsible for evaluating the audit team's collective professional competence. The issuance of a qualified opinion or disclaimer (modified opinion) due to a faulty audit approach that failed to provide sufficient coverage can never justify or compensate for poor audit execution on the part of the audit team. Thus, this final assessment of audit results requires an honest evaluation of the auditor's own performance. It is the auditor's responsibility to be candid about any shortcomings in the approach or execution and attempt to resolve these matters within the contractually agreed deadlines and/or discuss the issues, as necessary, with the auditee or other appropriate officials.

## **AUDIT QUALITY CONTROL REVIEW AND VALIDATION**

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A critical closing procedure is ensuring that the auditor has adhered to professional standards. Statements on Quality Control Standards (SQCS) are issued by the AICPA Auditing Standards Board (ASB) to provide the framework for developing and maintaining

an effective system of quality control. SQCS 8, *A Firm's System of Quality Control*, establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. Critical quality control issues are discussed next.

### **Independence: Auditor and Audit Organization**

AICPA and GAO general standards both address independence. Certified public accountants (CPAs) performing audits for governmental units are subject to these standards, as well as the standards imposed by the applicable state commission with jurisdiction over the audit. CPAs are bound to follow, and should be aware of, all applicable standards. Paragraph 3.02 of GAO's *Government Auditing Standards* (2011 revision; Yellow Book) states:

In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent.

Further, GAO standards explain that independence comprises:

- *Independence of mind*—the state of mind that permits the performance of an audit without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.
- *Independence in appearance*—the absence of circumstances that would cause a reasonable person and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team had been compromised.

The 2011 revision of GAO's *Government Auditing Standards* added a conceptual framework approach for independence to provide a way for auditors to assess auditor independence in unique circumstances that may exist and are not expressly prohibited. The conceptual framework is applied at the audit organization, engagement, and individual auditor level to:

- Identify threats to independence.
- Evaluate the significance of the identified threats.
- Apply safeguards when necessary to eliminate the threats or reduce them to an acceptable level.

The conceptual framework describes threats to independence, such as providing nonaudit services, as circumstances that could impair independence. Further, safeguards are defined as controls that eliminate or reduce to an acceptable level a threat's potential to impair independence. The revision clarified the requirements for continuing professional education (CPE), including highlighting the distinction between internal and external



specialists. The recent revision also clarifies for internal specialists that training in areas of auditing, the government environment, or the specific or unique environment in which the audited entity operates is required.

The standards for auditor independence attempts to respond to the existence of real, apparent, and perceived independence or, alternatively, impairments to independence. The auditor must be independent in fact as well as appearance. Although these standards apply to external auditors, most generally CPAs, the independence standards of the profession hold all practitioners, regardless of their employer, to similar standards. For auditors employed by a government, the independence issue would not often arise with respect to most audit assignments. But, except for the Yellow Book provisions, the standards provide minimal or no guidance to auditors employed by the government with respect to their independence.

In general, audit organizations will have developed internal quality control procedures to monitor compliance with independence rules. As a matter of practice, no audit organization will or should accept an audit engagement without first performing verification procedures to ensure that past or present endeavors and/or relationships do not compromise or appear to compromise the organization's independence. Similarly, audit staff should not be assigned to the audit without first ensuring that the individual auditors are free of independence impairments and that they remain free of impairments throughout the audit's life cycle.

Currently, many government agencies receiving audit services require that the audit organization represent that it is free of independence impairments (including an explanation of what procedures are followed to make the determination). In addition, individual representations from staff members are often required. In the interest of fully documenting the auditor's independence, quality control procedures should consider whether sufficient procedures were performed (including documentation, as discussed earlier) to ensure compliance with independence requirements.

### **Audit Documentation**

Unlike the AICPA's generally accepted auditing standards (GAAS), GAO's *Government Auditing Standards* explicitly provides a separate fieldwork standard addressing the quality of audit documentation. Paragraph 4.15 requires that the auditor document:

- Supervisory review, before the report release date, of the evidence that supports the findings, the conclusions, and recommendations contained in the auditors' report.
- Any departures from the GAGAS [generally accepted government auditing standards] requirements and the impact on the auditors' conclusions when the audit is not in compliance with applicable GAGAS requirements due to law, regulation, scope limitations, restriction on access to records, or other issues impacting the audit.

All work performed by the auditor in support of his or her assertions must be documented in the work papers to substantiate the procedures and/or tests that are performed and the conclusions reached. To facilitate the review of work performed, every work plan, procedure, step, task, and/or test is to be referenced to the work paper containing or displaying evidence of the work performed, including the individual(s) who performed the procedures and/or reviewed the work. Additionally, each work paper should stand on its own, having sufficient documentation to allow the reviewer to reach the same conclusion as the individual responsible for performing the procedure. In general, well-developed work papers that fully support the auditor's work and assertion should include these items:

- Work paper reference
- Cross-reference to supporting work papers (as applicable)
- Initials of the individual responsible for performing the procedure
- Initials of the individual responsible for reviewing the work paper
- Description of the source of the document or documents reviewed
- Purpose of the work paper
- Procedure(s) performed
- Conclusions drawn from the work performed
- A well-thought-out indexing scheme that enables all members of the audit team, as well as the independent technical reviewer, to quickly locate specific aspects of the audit, such as planning, cycle documentation, internal control assessments testing, or accounting and auditing issues

During the course of an audit, internal control issues may be uncovered that impact the audit and/or must be brought to the attention of the auditee. These issues or findings include material weaknesses, significant deficiencies, and management letter comments, discussed in more detail later in this chapter. Yellow Book standards require that the documentation of these issues include:

- *Description of the finding (condition)*. A concise summary of the nature of the finding including references to supporting work papers where additional information about the finding can be found. The description of the finding includes a discussion of the condition disclosed by the audit procedures (e.g., what is wrong with the process, a description of errors found, etc.).
- *Criteria*. In general, findings such as weaknesses in internal control refer to events or conditions that violate certain rules. These rules can be as formal as specific Federal internal control or accounting requirements or simply the application of common sense and some best practices. In short, the criteria explain why the condition described earlier is a problem.
- *Cause*. Typically, the cause will be the absence of effective prevention controls, clerical errors, or both. Clerical errors may be the result of a lack of training or

cycle documentation as well as carelessness or incompetence. Although carelessness and incompetence may require tact when discussed with management, the auditor cannot ignore these conditions.

- *Effect.* A discussion of the actual and/or potential effect of the condition on the financial statements and/or the accomplishment of specific internal control objectives (e.g., safeguarding assets).

The audit documentation also includes the auditor's evaluation of the severity of the audit finding and whether the condition should be considered a *significant deficiency* or a *material weakness*, which will need to be included in the auditor's report on internal controls.

Because reportable findings of this nature typically require the auditor to make a special reporting or issue related documentation, the audit documentation in support of the finding must also include a description of the actions the auditee should take to address the finding. To the extent that the issue has been discussed with the auditee, the auditee's response should also be documented.

### **Staff Assignment, Supervision, and Competence**

GAO's general standard addressing competence (paragraph 3.69) states:

The staff assigned to perform the audit must collectively possess adequate professional competence needed to address the audit objectives and perform the work in accordance with GAGAS.

### ***Assignments and Responsibilities***

The execution of an efficient and effective audit requires a staff size and skill mix (including specialists and subject matter experts [SMEs]) commensurate with the requirements of the audit's magnitude, scope, and complexity. Typically, the level of individuals assigned to a specific engagement will range from junior or staff-level personnel to partner or equivalent-level professionals in a governmental audit organization. The determination and assignment of the number, quality, and type of staff (including specialists and SMEs) required should occur as early as possible during the planning phase of the engagement. This determination is based on risk assessments and other matters of professional judgment.

The successful execution of an audit requires audit procedures to be delegated to auditors with the requisite skill and experience. The next summary describes responsibilities typically associated with the different levels found in an audit. The discussion addresses the traditional partner, manager, senior accountant, and staff accountant hierarchy found in most commercial firms. However, it should be understood that these titles vary among firms. In addition, while government audit organizations include partner-level auditors, the title *partner* is clearly not appropriate for these organizations.

- *Audit partners* or the equivalent *governmental audit directors* are responsible for overall audit management and the ultimate completion of the engagement in compliance with professional guidelines and all Federal requirements. Most audit engagements should include at least one partner or governmental audit director who is responsible for audit execution and a second partner or governmental audit director (or experienced audit manager for less complex engagements) who is responsible for the performance of an independent quality control review of the audit. This latter individual should not be involved in the daily performance of the audit.

The audit partner is responsible for reviewing and approving the overall audit approach, the definition of materiality, and the identification of tolerable audit risk. As a rule, partners or governmental audit directors are involved in the development of the audit plan, the review of selected audit work papers, and the resolution of audit and accounting issues. As needed, the partner or governmental audit director also participates in the development and execution of audit procedures affecting the more complex areas of the audit. Finally, the audit partner or governmental audit director has the ultimate responsibility for ensuring that sufficient audit coverage was obtained to support the assertions included in the auditor's reports.

- *Audit managers* work closely with the partners or governmental audit directors in the development of the audit approach and audit plan and, as a rule, supervise the audit senior's execution of day-to-day management responsibilities. Depending on the complexity of audit procedures, audit managers develop and/or review and approve audit programs and play a major role in the early identification and resolution of complex or significant audit and accounting issues.
- *Audit seniors* are responsible for the execution of day-to-day management activities, the development of audit programs, and the supervision of staff auditors. In most instances, an audit senior participates in all four phases of the audit and is involved in executing or assisting with all aspects of the audit, including supervision of audit staff, work paper documentation and review, drafting reports and findings, addressing most management and accounting/auditing issues, and the execution of complex audit procedures.
- *Staff auditors* are responsible for performing less complex procedures and tests and work under the supervision of more senior personnel.

### **Supervision**

The AICPA's *Code of Conduct* states in part, that "due care requires a member to . . . supervise adequately any professional activity for which he or she is responsible." Procedures must be in place to ensure that all work performed is reviewed at various stages of the audit.

Although practice varies somewhat from engagement to engagement depending on the circumstances and the competence/experience level of seniors and staff, a sound supervision approach will ensure that, at a minimum, all work papers and reports prepared by staff auditors are reviewed by audit senior(s) and/or the audit manager. This review takes place continually, as the audit progresses, and not just at the conclusion of audit fieldwork.

Procedures should require that all work papers prepared by the audit senior are reviewed by the audit manager and/or partner or governmental audit director and that all work papers prepared by the audit manager are reviewed by the audit partner or governmental audit director. In addition, a second partner or governmental audit director should review all original work prepared by partners or governmental audit directors, and all work products and reports should be independently reviewed by a partner or governmental audit director with no other involvement in the audit. This same individual could also be responsible for the review of original audit work papers developed by the partner(s) participating in the audit. Finally, it is important that work paper documentation clearly shows the review process (e.g., by requiring individuals reviewing the work to sign the work paper, either manually or through electronic documentation tools, and state their agreement with the conclusions reached, when applicable, and/or completeness of the procedures performed).

### ***Continuing Professional Education***

The AICPA and GAO both recognize the importance of staying abreast of developments affecting Federal auditing and accounting. As a means to achieving this perpetual competence, CPE requirements beyond those contained in the AICPA's GAAS have been imposed by GAO on all audits performed in accordance with Yellow Book standards. In addition, the AICPA and state agencies having jurisdiction over CPA licenses also issue CPE requirements. The auditor must be aware of these requirements and ensure compliance with both or all.

It is important that during the planning Phase I, the auditor consider whether all personnel assigned to the audit are in compliance with *Government Auditing Standards* and other applicable CPE requirements (or will be by the completion of the audit). As a matter of routine, closing procedures should ensure that audit work papers sufficiently document compliance with CPE requirements for all participating professionals subject to the requirements. In the words of GAO (paragraph 3.76), these continuing professional education requirements apply to all auditors performing work under GAGAS, including auditors planning, directing, performing fieldwork, or reporting on an audit or attestation engagement subject to GAGAS. These individuals must complete, every two years, at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates.

## ISSUING THE INDEPENDENT AUDITOR'S REPORTS

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In general, reports issued in connection with audits of Federal Agencies in accordance with GAO and OMB requirements, particularly OMB Bulletin 07-04, must include:

- The Federal auditee's financial statements.
- A report by the auditor on the Federal auditee's internal controls.
- A report by the auditor on the Federal auditee's compliance with laws and regulations.
- Management letters issued by the auditor to the Federal auditee.
- Special-purpose reports that may be required of the auditor.

The appendix to this chapter provides examples of selected reports. The reports on financial statements, internal controls, and compliance with laws and regulations may be combined into one or two reports.

### **Auditor's Report on Financial Statements**

The auditor's report should state whether the department or agency's principal financial statements (including related notes) are fairly stated in all material respects in accordance with the GAAP, which, as noted in earlier chapters, are promulgated by Federal Accounting Standards Advisory Board (FASAB). The auditor's report must comply with AICPA guidance, specifically sections AU-C 700, 705, and 706. The auditor's opinion or report usually covers these principal statements:

- Balance sheet
- Statement of Net Costs
- Statement of Changes in Net Position
- Statement of Budgetary Resources
- Statement of Custodial Activity (when applicable)

In addition to the listed statements, the auditor will report on required supplementary information, including:

- Management's discussion and analysis (MD&A).
- Required supplementary stewardship information (e.g., including property, plant, and equipment; investments; and social insurance information).
- Required supplementary information.

Generally, contracts for audit issued by a Federal department or agency require that audit reporting procedures follow the GAO *FAM*. Unless the auditor has been engaged to audit the required supplementary information, the auditor must mention that limited procedures were performed (e.g., inquiries of management) and disclaim an opinion on the information.

### ***Audit Opinions on Federal Financial Statements***

The specific audit opinion issued on the financial statements depends on the auditor's findings and ability to validate the implicit and explicit assertions by agency management with respect to its financial statements. An unmodified, or clean, audit opinion cannot be issued given any of these circumstances:

- If the financial statements are not prepared in accordance with applicable accounting principles, the auditor's report should identify the GAAP departure and its effect on the financial statements. Depending on the magnitude of the departure and its subsequent effect, the auditor will qualify or issue an adverse opinion on the agency's financial statements.
- If the auditor is unable to obtain sufficient competent evidential matter to support management's assertions, he or she should disclaim an opinion or, depending on the auditor's evaluation of the potential impact of the uncertainty created by the lack of sufficient evidential matter, issue a qualified ("except for") opinion. Any qualified audit opinion should explain the nature of the uncertainty. Uncertainties arise as a result of a number of factors, including:
  - Externally imposed scope limitations (including limiting auditor access to data as well as inability to obtain competent evidential matter prior to reporting deadlines).
  - Internal control weaknesses that cannot be overcome by performing additional or extended audit procedures.
  - The presence of contingencies that cannot be reasonably estimated to meet the financial statement reporting requirements set forth in FASAB Statement of Federal Financial Accounting Standard 5, *Accounting for Liabilities of the Federal Government*.

### ***Nature and Content of Audit Opinions and Federal Financial Statements***

The accounting and financial reporting contained in the principal financial statements of Federal departments and agencies—that is, the GAAP for Federal entities—were initially delineated by FASAB. During the 1990s, Congress, in several laws, codified FASAB's standards and detailed other financial management requirements for examination and report during an annual audit. Soon after, OMB, by its circulars and bulletins relative to Federal Agency financial statements, duplicated the congressional financial reporting criteria, prescribed additional guidance, and imposed other requirements to be implemented during the annual financial reporting phase.

Federal auditing requirements—GAAS for Federal audits—are structured in a somewhat similar fashion. The auditor of a Federal entity must adhere to all of the AICPA's GAAS plus the additional standards required by GAO's *Government Auditing Standards*, and requirements imposed on Federal audits by OMB in its circulars and bulletins

(of particular note is Bulletin 07-04, which imposes more detailed audit procedures and provides sample audit opinions and audit assurance requirements).

### ***Elements of the Audit Report on Agency Financial Statements***

In many ways, the auditor's report on Federal financial statements parallels the auditor's report on the financial statements of an organization in the private sector. However, differences do exist and will continue to arise as Congress identifies issues that require examination and reporting. To ensure the currency of compliance with emerging Federal audit requirements, auditors must annually examine OMB and GAO issuances as well as those of agency Inspectors General for emerging issues warranting audit coverage.

The content of the standard (unmodified) independent auditor's report is set forth in AU-C 700 and includes the following elements:

**Introductory Paragraph.** (1) identifies the entity whose financial statements have been audited, (2) states that the financial statements have been audited, (3) identifies the title of each statement that the financial statements comprise, and (4) identifies the date or period covered by each financial statement that the financial statements comprise.

**Management's Responsibility for the Financial Statements.** A statement regarding management's responsibility for the financial statements, as well as related internal controls which promote the preparation of fairly stated statements free from material misstatement due to errors and/or fraud.

**Auditor's Responsibility.** (1) A statement that the auditor is responsible for the expression of an opinion on the statements based on standards generally accepted in the United States. (2) A general description of the procedures typically used in an audit, including the auditor's consideration of internal control. This latter consideration would be following by a disclaimer on internal controls, unless the auditor is required to issue such an opinion as is the case, for example, with most SEC filings.

**Opinion Paragraph.** The standard (unmodified) report concludes with an opinion that the statements are fairly stated in accordance with Generally Accepted Accounting Principles.

### **Auditor's Name, Location, and Signature.**

**Date of the Audit Report.** As noted in Chapter 6, the requirements for the end of fieldwork were modified in SAS 103. According to SAS 103, the report date is the date when all required data to support an opinion (including supervisory review) on the financial statements have been obtained.

All of the information above will typically appear on an unqualified report on Federal financial statements. However, the report on Federal financial statements is more extensive



and is required to refer to the requirements set forth by GAGAS, as well as OMB audit guidance. In addition to reporting on financial statements, audits of Federal Agencies require that the auditor report on the results of tests performed on internal controls, as well as tests of compliance with Federal laws, policies, and regulations. The Reports on Internal Controls and Compliance with Laws and Regulations may be combined with the Report on the Financial Statements or may be issued separately.

By way of clarification, it is important to note that in the Federal arena the authoritative body for U.S. Generally Accepted Accounting Principles is the Federal Accounting Standards Advisory Board (FASAB), while for private sector entities it is the Financial Accounting Standards Board (FASB).

### **Auditor's Report on Internal Controls**

The report on internal controls (like the report on compliance with laws and regulations, discussed next) is a unique requirement of governmental auditing. GAAS require only that reportable conditions (including material weaknesses) relative to internal controls are disclosed, and then only to an audit committee or, in its absence, the board of directors and/or appropriate management levels. Further, while the AICPA's GAAS state that written communication is preferable, this is not a requirement as long as the verbal communication is documented in the work papers. When auditing a Federal entity, however, such practices with respect to reporting on controls are not acceptable.

The second reporting standard of *Government Auditing Standards* requires that:

When providing an opinion or a disclaimer on financial statements, auditors should include in their report on the financial statements either a: (1) description of the scope of the auditors' testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements and the results of those tests or an opinion, if sufficient work was performed, or (2) reference to the separate report(s) containing that information. If auditors report separately, the opinion or disclaimer should contain a reference to the separate report containing this information and state that the separate report is an integral part of the audit and should be considered in assessing the results of the audit.

Further, OMB Bulletin 07-04 sets forth these requirements for the auditor's internal control report required in relation to a financial statements audit of a Federal entity:

- The auditor's report must contain a statement that, in connection with the financial statement audit of the agency, the auditor:
  - Obtained an understanding of the design of internal controls;
  - Determined whether the controls were operational; and
  - Performed tests of internal controls.

- The auditor's report must contain a definition of the scope of the tests performed and either an opinion on internal control or (as is the more common practice) a disclaimer of opinion and the reasons an unqualified audit opinion is not rendered.
- The auditor's report must contain a description of significant deficiencies and material weaknesses identified during the audit, including the identification (if applicable) of material weaknesses that were not included in the auditee's reporting required under the Federal Managers' Financial Integrity Act (FMFIA).
- The auditor's report must contain a reference to the issuance of a separate management letter (if applicable).

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. With respect to both *significant deficiencies* and *material weaknesses*, auditors must ensure that the applied definitions are required to be employed by the conditions or auditing standards noted in the audit engagement contract. At times, the applied definitions related to these circumstances have varied among Congress (in its laws), OMB (in its circulars and bulletins relating to Federal audits), GAO (in its guidance and auditing standards), and *Internal Control—Integrated Framework* of the Treadway Commission of the Committee of Sponsoring Organizations (COSO), which has been adopted by the Federal Government as guidance for its practices.

### ***Nature and Content of the Audit Report on Federal Agency Controls***

The auditor's report on internal controls should include each of the elements discussed next.

**Introductory Paragraph.** The initial paragraph of the auditor's report on an agency's internal controls must state that an audit was made of the agency's principal financial statements as of and for the fiscal years audited and that the auditor has issued an audit report thereon, citing the date of that audit report. The auditor must report that the audit was conducted in accordance with the AICPA's GAAS; the standards applicable to financial audits contained in the *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB's applicable circulars and bulletins.

**Scope Paragraph.** The auditor is required to mention that when planning and performing the financial statement audit, the agency's internal control over financial reporting was considered by:

1. Obtaining an understanding of the agency's internal control.
2. Determining whether internal controls had been placed in operation.
3. Evaluating and assessing control risk.
4. Performing tests of controls in order to determine the nature, timing, and extent of the auditing procedures applied in the audit for the purpose of expressing an opinion on the financial statements.

Auditors are permitted to limit internal control testing to those controls necessary to achieve the internal control objectives described in OMB Bulletin 07-04.

Although not stated, no specific audit or special examination is required to be made of the entity's controls, separate from tests made to audit the agency's financial statements. The controls information reported on are data compiled in conjunction with the audit of the financial statements.

**Assurance and Disclaimer Paragraphs.** These paragraphs of the report on internal controls contain comments on limitations of tests performed and disclaimers to the effect that no audit opinion is provided on an agency's controls. Some of the more common language includes:

- Our consideration of internal control was for the limited purpose described in the first paragraph of this section, and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies.
- Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

In these paragraphs, more than one statement is made to the effect that the current objective of testing controls is not to provide an assurance or an audit opinion on internal controls. However, if the auditor notes significant weaknesses when testing internal controls as part of the audit of the financial statements, these deficiencies must be described and reported in the auditor's report on internal controls. *Government Auditing Standards* require that these control deficiencies be reported, even though the conditions may have been immediately corrected by the agency. In contrast, if similar control deficiencies were noted in an audit of a private sector entity, the AICPA's GAAS would not require the auditor to make a reporting in the audit report.

### **Auditor's Report on Compliance**

With respect to the auditor's report on a Federal Agency's compliance with laws and regulations, the auditor must look to OMB rather than the AICPA for guidance. OMB Bulletin 07-04 sets forth these requirements for the internal control report:

- The auditor must report events of noncompliance with laws and regulations disclosed by the audit (unless deemed inconsequential by the auditor).
- The auditor must report noncompliance with Federal internal control requirements including applicable provisions of the FMFIA.
- The auditor must report on the scope of tests performed and provide either an audit opinion on compliance or (as is the more common practice) a disclaimer of an audit opinion.

In connection with noncompliance with the Federal Financial Management Improvement Act (FFMIA), the auditor's report should:

- Group findings together based on the three FFMIA requirements that Federal Agencies comply with:
  - Federal financial management systems requirements.
  - Federal accounting standards.
  - The U.S. standard general ledger at the transaction level.
- Identify the entity or organization responsible for the noncompliance.
- Describe the noncompliance, disclosing its nature, extent, and probable cause and relevant comments from management and other appropriate personnel.
- Provide recommendations, including an implementation timetable.

### ***Special, Additional Audit Report***

An auditor's report on compliance with laws and regulations that could have a direct and material effect on the financial statements is not a requirement for conformance with the AICPA's GAAS. Like the report on internal controls, this report is another distinguishing criteria imposed by *Government Auditing Standards*. Only *Government Auditing Standards* require the auditor to report on the results of tests of compliance with laws and regulations.

The second GAGAS reporting standard states that when providing an opinion or disclaimer on financial statements, auditors should include in their report on the financial statements either:

- a. A description of the scope of the auditors' testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements and the results of those tests or an opinion, if sufficient work was performed or
- b. A reference to the separate report(s) containing that information. If auditors report separately, the opinion or disclaimer should contain a reference to the separate report

containing this information and state that the separate report is an integral part of the audit and should be considered in assessing the results of the audit.

The standards of both the AICPA and GAO require the testing of any transaction (whether laws, regulations, contracts, grant agreements, financial covenants, etc.) that could have a direct and material effect on the financial statements. However, only GAO's *Government Auditing Standards* require the auditor to report on the fact that tests were made for compliance.

### ***Nature of Report on Tests for Compliance***

The auditor's report on compliance with laws and regulations should include each of the elements discussed next.

**Introductory Paragraph.** Reference is made to the audited principal financial statements in the introductory paragraph, as tests for compliance with laws and regulations are typically made in conjunction with an audit of an agency's financial statements. In a sense, this audit report, like the earlier report on controls, is a by-product of tests and audit procedures employed during the overall audit of the Federal entity's financial statements. To comply with *Government Auditing Standards*, a separate audit need not be made, nor a separate examination undertaken, to test a Federal entity's compliance with laws and regulations that could have a direct and material effect on the financial statements. *Government Auditing Standards* require that there be a separate reporting of the tests made and of the results of those tests.

**Scope Paragraph.** To comply with GAO's standards, the auditor must report on the tests performed relative to the entity's compliance with provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and regulations of OMB Bulletin 07-04 as well as requirements referred to in the FFMIA.

**Assurance, Disclaimer Paragraphs.** In the compliance report, the auditor disclaims an audit opinion and audit assurances with respect to compliance with certain provisions of laws and regulations stating that an audit opinion on compliance was not an objective of the financial statement audit. In addition, the auditor notes that tests were not made in compliance with all laws and regulations applicable to the Federal entity.

Alternatively, though, the auditor is required to provide an audit assurance (a positive assurance) on the results of these tests. For example, this assurance might read:

The results of our tests of compliance with the laws and regulations . . . disclosed no instances of noncompliance with the laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 07-04.

Concurrently, though, the auditor provides a disclaimer:

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

As a matter of practice, both the report on compliance and the report on internal control should include management's responses indicating concurrence or disagreement and, when applicable, future corrective efforts.

The issuance of a combined auditor's report encompassing the Auditor's Report on Federal Financial Statements, the Report on Internal Controls, and the Report on Compliance with Laws and Regulations is also acceptable.

### **Management Letters**

The management letters transmitted by the auditor to the auditee may cover any areas identified during the audit that need not be disclosed in the report on internal controls, but where, in the auditor's opinion, opportunities for improvements in internal controls and/or an operating efficiency exist.

### **Special-Purpose Reports**

The Department of the Treasury is responsible for the preparation of the consolidated financial statements of the executive branch of the United States Government. OMB Bulletin 07-04 requires those agencies significant to the preparation of the financial report of the U.S. government to submit special-purpose financial statements to the Department of the Treasury.

The special-purpose financial statements include reclassified balance sheets, statements of net cost and changes in net position, and accompanying notes. They are designed to facilitate the government-wide financial statement consolidation process at the Treasury. The audit scope for these agencies must be designed to ensure that the audited statements of these agencies are reclassified in accordance with the Treasury's requirements. A sample report is included in OMB Bulletin No. 07-04 and is presented in the appendix to this chapter.

## APPENDIX TO CHAPTER 12

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This appendix includes illustrations of selected auditor's reports to be issued in connection with audits of Federal Agencies. The illustration of the auditor's opinion on the special-purpose Financial Statements was reproduced from OMB's Bulletin 07-04, *Audit Requirements for Federal Financial Statements*.

The reports are:

- Independent Auditor's Report on Financial Statements
- Independent Auditor's Report on Internal Controls and Compliance and Other Matters
- Independent Auditor's Report on Special-Purpose Financial Statements.

### ILLUSTRATIVE INDEPENDENT AUDITOR'S REPORT

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#### Opinion on Financial Statements

To the [Agency Head] and Inspector General of [Agency]

#### Report on the Financial Statements

We have audited the accompanying consolidated balance sheets of the [Agency] as of September 30, 20X2, and 20X1, and the related consolidated statements of net costs, changes in net position, and combined statements of budgetary resources (hereinafter referred to as the "financial statements") for the year then ended.

#### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

#### Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards require that we plan and

perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

### **Opinions**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the respective financial position of the [Agency] as of September 30, 20X2, and 20X1, and its net cost of operations, changes in net position, and budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

### **Other Matters**

#### ***Required Supplementary Information***

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis, Required Supplementary Information, and Required Supplementary Stewardship Information be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by OMB Circular A-136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.



**Other Information**

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. Other Accompanying Information is presented for purposes of additional analysis and is not required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

**Other Reporting Required by Government Auditing Standards**

In accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, we have also issued our report dated [Report Date], on our consideration of the [Agency]'s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, in considering [Entity]'s internal control over financial reporting and compliance.

[Firm's signature]

[City, State]

[Date]

**ILLUSTRATIVE INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE AND OTHER MATTERS**

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**To the [Agency Head] and Inspector General of [Agency]**

We have audited, in accordance with the auditing standards generally accepted in the United States of America; standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, Audit Requirements for Federal Financial Statements, as amended, the financial statements of the [Agency], as of and for the year ended September 30, 20X2, and the related notes to the financial statements, and have issued our report thereon dated [Report Date]. The management of the [Agency] is responsible for establishing, maintaining, and assessing internal control related to financial reporting and compliance, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act of 1982 (FMFIA) are met.

### Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the [Agency]'s internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the [Agency]'s internal control. Accordingly, we do not express an opinion on the effectiveness of [Agency]'s internal control over financial reporting or on management's assertion on internal control included in Management's Discussion and Analysis.

We limited our internal control testing to those controls necessary to achieve the OMB Bulletin No. 07-04, as amended, control objectives that provide reasonable, but not absolute assurance, that: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in compliance with laws governing the use of budget authority, Government-wide policies and laws identified in Appendix E of OMB Bulletin No. 07-04, as amended, and other laws and regulations that could have a direct and material effect on the financial statements.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying schedule of findings and questioned costs we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies summarized in the following paragraphs to be material weaknesses.

[List the material weaknesses.]

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies summarized in the following paragraphs to be significant deficiencies.

[List the significant deficiencies.]

### Compliance and Other Matters

As part of obtaining reasonable assurance about whether the [Agency]'s financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 07-04, as amended, that we determined were applicable. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, and which are summarized in the following paragraphs.

[List the noncompliance items.]

### [Agency]'s Response to Findings

[Agency]'s response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. [Agency]'s response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

### Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

[Firm's signature]

[City, State]

[Date]

## ILLUSTRATIVE INDEPENDENT AUDITOR'S REPORT ON SPECIAL-PURPOSE FINANCIAL STATEMENTS

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### To the [Agency Head] and Inspector General of [Agency]

We have audited the accompanying reclassified balance sheets as of September 30, [insert years] and the related reclassified statements of net cost and changes in net position for the year then ended, and the statements of social insurance (if applicable) (hereinafter

referred to as the special-purpose financial statements) contained in the special-purpose closing package of [Agency]. These special-purpose financial statements are the responsibility of [Agency]'s management. Our responsibility is to express an opinion on these special-purpose financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in U.S. Government Auditing Standards, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the special-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the special-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall special-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The accompanying special-purpose financial statements and accompanying notes contained in the special-purpose closing package have been prepared for the purpose of complying with the requirements of the U.S. Department of the Treasury's Financial Manual (TFM) Volume I, Part 2, Chapter 4700, as described in note X, solely for the purpose of providing financial information to the U.S. Department of the Treasury and U.S. Government Accountability Office to use in preparing and auditing the *Financial Report of the U.S. Government*, and are not intended to be a complete presentation of [Agency]'s financial statements.

In our opinion, the special-purpose financial statements and accompanying notes referred to above present fairly, in all material respects, the financial position of [Agency] as of September 30, [Year], and its net costs and changes in net position for the year then ended, and the statements of social insurance (if applicable) in conformity with accounting principles generally accepted in the United States of America and the presentation pursuant to the requirements of the TFM Chapter 4700.

The information included in the Other Data is presented for the purpose of additional analysis and is not a required part of the special-purpose financial statements, but is supplementary information required by the TFM Chapter 4700. We have applied certain limited procedures, which consisted principally of inquiries of management regarding methodology and presentation of this information. We also reviewed such information for consistency with the related information presented in [Agency]'s financial statements. However, we did not audit this information, and accordingly, we express no opinion on it.

In accordance with U.S. Government Auditing Standards and OMB Bulletin No. 07-xx, we have also issued reports dated [Report Date] on our consideration of [Agency]'s internal control over financial reporting and its compliance with certain provisions of laws

and regulations. Those reports are an integral part of an audit of general-purpose financial statement reporting performed in accordance with U.S. Government Auditing Standards and OMB Bulletin No. 07-04, as amended, and should be read in conjunction with this report in considering the results of our audit.

In planning and performing our audit of the special-purpose financial statements, we also considered [Agency]'s internal control over the financial reporting process for the special-purpose financial statements and compliance with the TFM Chapter 4700. Management is responsible for establishing and maintaining internal control over financial reporting, including Other Data, and for complying with laws and regulations, including compliance with the TFM Chapter 4700 requirements.

Our consideration of internal control over the financial reporting process for the special-purpose financial statements would not necessarily disclose all matters in the internal control over the financial reporting process that might be significant deficiencies. Under standards issued by the American Institute of Certified Public Accountants, significant deficiencies are deficiencies in internal control, or a combination of deficiencies, that adversely affects [Agency]'s ability to initiate, authorize, record, process, or report financial data reliably and in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the special-purpose financial statements being audited that is more than inconsequential will not be prevented or detected. Material weaknesses are significant deficiencies, or a combination of significant deficiencies, that result in a more than remote likelihood that material misstatements in relation to the special-purpose financial statements being audited will not be prevented or detected.

We found no material weaknesses in internal control over the financial reporting process for the special-purpose financial statements, and our tests of compliance with the TFM Chapter 4700 requirements disclosed no instances of noncompliance that are required to be reported under U.S. Government Auditing Standards and OMB Bulletin No. 07-04, as amended. However, providing opinions on internal control over the financial reporting process for the special-purpose financial statements or on compliance with the TFM Chapter 4700 requirements were not objectives of our audit of the special-purpose financial statements and, accordingly, we do not express such.

[Signature]

[Report Date]



## **PART IV**

# **NATURE OF SELECTED FEDERAL AUDITS**





# 13 AUDITING AND EVALUATING FEDERAL IT SYSTEMS

In the Federal Government, information technology (IT) auditing is an integral component of the audit process. This chapter has three objectives. First, it provides auditors an overview of the Federal IT audit approach based on guidance published in the Government Accountability Office's (GAO) *Federal Information System Controls Audit Manual (FISCAM)*, dated February 2, 2009. As IT auditing is not limited to supporting just financial statement audits, this chapter introduces other types of IT audits such as those performed under the Federal Information Security Management Act (FISMA) of 2002 and Statement on Standards for Attestation Engagements (SSAE) 16, *Reporting on Controls at a Service Organization*. Second, this chapter provides an overview of the most significant laws, Federal regulations, and guidance from the Office of Management and Budget (OMB) and the National Institute of Standards and Technology (NIST). Under the authority of the FISMA legislation, these two organizations set the security policies and procedures for the executive branch agencies and departments. Third, this chapter provides auditors perspective on how changes within the IT industry, such as the evolution of cloud computing, are affecting the role of the IT auditor and the services provided to clients.

## UNDERSTANDING THE NEED FOR IT SECURITY

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Cybersecurity is an ongoing focus for Federal Agencies as their information systems are frequently under attack by criminals and foreign agents. Past, present, and ongoing efforts by the U.S. government have resulted in laws, regulations, acts, methodologies, and guidance to aid and enforce protection of Federal information and information systems. The protection of data and information, whether electronic or in print form, is critical to promoting confidentiality, integrity, and availability, which forms the foundation for information security. Confidentiality entails preventing the unauthorized disclosure of information. Integrity involves preserving information and ensuring it is not maliciously modified. Availability ensures information is available when needed and not susceptible to attacks that would prevent the information from being accessed. Confidentiality, integrity, and availability are key security concepts considered when organizations develop and implement information security programs.

## FEDERAL IT AUDIT PROCESS

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The information system audit process consists of three phases (consistent with *FISCAM*). The planning phase entails planning the steps to accomplish the audit objective and obtaining sufficient and appropriate evidence to support the auditors' findings and conclusions.<sup>1</sup> The testing phase entails testing whether information systems controls relevant to the audit objectives exist, and, if so, whether they are effective. The reporting phase includes reporting on the current state of the information system control environment related to the audit objectives and whether any control weaknesses exist.

Exhibit 13.1 and the following discussion provide an overview of the methodology for the evaluation and testing of Federal information systems from an IT auditor's perspective. Observant readers will note there are many process similarities between an IT audit and a financial statement audit. This section attempts to highlight areas of difference and those aspects requiring additional auditor attention. While *FISCAM* was developed specifically to support Federal financial statement audits, the methodology and approach can be applied to FISMA and privacy audits as well.

### Phase I—Planning

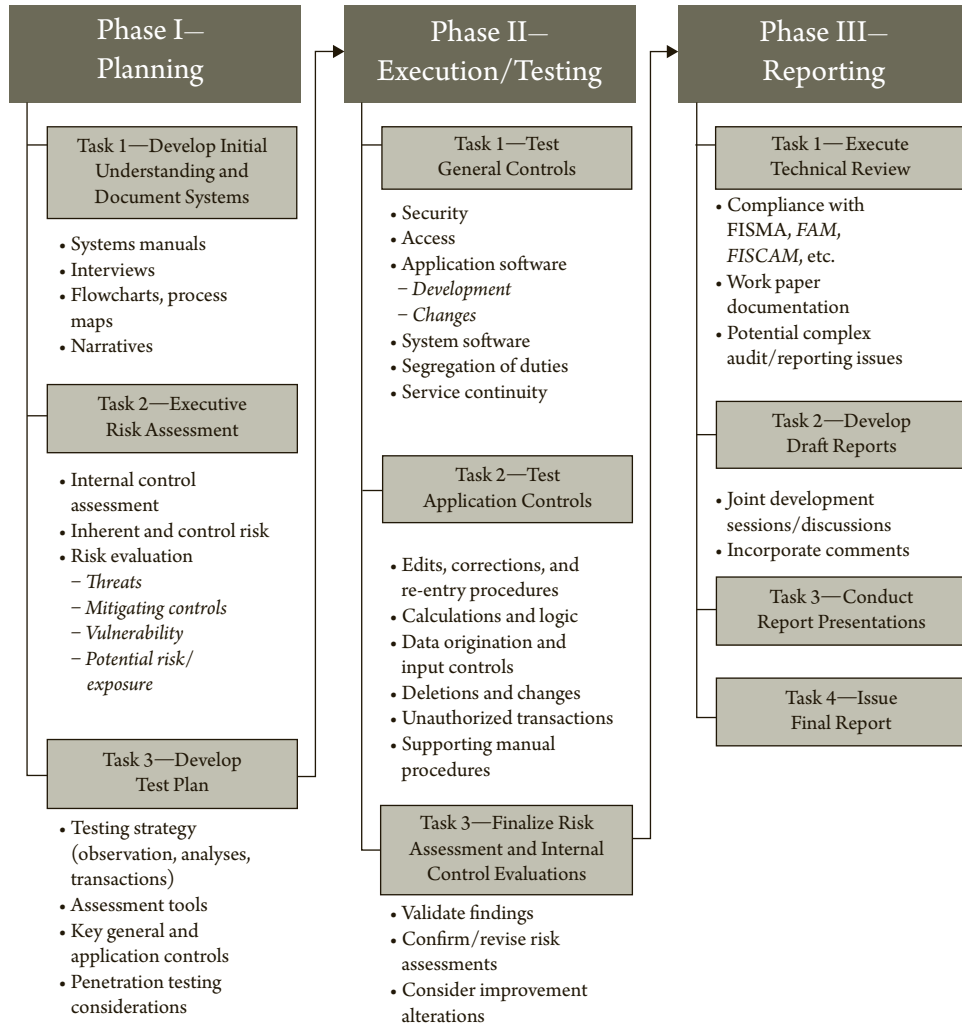
The steps presented in the planning phase do not have to be performed sequentially. Some may be even executed concurrently, depending on the size of the audit team and the nature, timing, and extent of the audit.

The nature, extent, and timing of the information systems audit depends on the audit objectives, size and complexity of the entity, experience with the entity, and knowledge of the entity's business. The *nature* of the audit entails the steps and methodologies used in gathering evidence to evaluate the information systems to be tested. It includes evaluating controls by inquiry, observation, and/or inspection. The *extent* refers to the level of testing necessary to evaluate each control in each area, whether it is logical<sup>2</sup> and physical access controls for the general control area of Access Controls, or disaster recovery and continued operations controls for the area of Contingency Planning within the *FISCAM* Methodology. The extent includes the length of time during the audit period that the auditor is relying on the operating effectiveness of the control(s). The *timing* component entails when the audit occurs and what period(s) will be assessed. For instance, the timing of tests of controls relates to when the evidence about the operating effectiveness of the controls is obtained and the period of time to which it applies. The nature, timing, and extent of the

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<sup>1</sup> U.S. Government Accountability Office *Government Auditing Standards*, 2011 Revision, Paragraphs 6.03 and 6.07.

<sup>2</sup> Logical access controls refer to information security controls that require users, network devices, and/or network services to identify, authenticate, and authorize access to a network or application using a unique ID and password or similar mechanism (i.e. physical token, fingerprint, or digital certificate).



**EXHIBIT 13.1 Audit Process Phases**

audit are defined during the planning of the audit; however, they may be altered during the information-gathering and testing stages.

The planning phase entails understanding the overall audit objectives and related scope of the information system controls audit and obtaining an understanding of the entity and its operations and key business processes. Of particular importance during the planning phase is obtaining an understanding of the entity's networks and identifying

key areas of audit interest (files, systems, applications, locations). This high-level understanding enables the IT auditor to initially assess information system risk, identify critical control points (network interfaces), and obtain an initial understanding of information system controls. In conjunction with the financial audit team, the IT auditor should perform procedures to identify relevant laws and regulations, considering the risk of fraud, and results from previous attestation and audit engagements.

### **Audit Objectives**

The audit objectives are defined and documented based upon the type of audit being conducted, whether it is evaluating information system controls for compliance with NIST guidance; evaluating agency compliance with privacy collection and disclosure requirements; or supporting the objectives of completeness, accuracy, and cutoff in a financial audit. Audit objectives may include:

- Assessing the effectiveness of controls related to logical and physical access.
- Evaluating how an information system protects the confidentiality, integrity, and availability of sensitive data contained within it.
- Assessing the completeness and accuracy of financial data extracted from a financial application.

Audit objectives should be formally stated and assist the IT auditor and others in determining whether items are or are not material and significant within the scope of the audit.

The audit team's time should be prioritized on audit objectives of significant importance. Also, an audit strategy and scope should be formulated based on the organizational entity and the technology areas, systems, applications, and controls to be tested (general and/or business process application).

An essential consideration during planning is ensuring that the audit meets the requirements set forth by oversight agencies, such as OMB and GAO, as well as specific laws and regulations and agency developed requirements. A more detailed discussion of these standards and laws appears later in this chapter.

### **Entrance Briefing**

The entrance briefing, also referred to as the kickoff meeting, is typically conducted by senior members of the engagement team with the agency's management, contracting officer, and audit team present. The meeting effectively kicks off the audit or review and provides an overview of *who* (audit company and staff), *what* (what is being audited), *when* (the duration of the audit), *where* (where the audit will take place), and *why* (why the audit is being conducted). The entrance briefing is conducted regardless of whether the effort is a formal audit, a review, or an inspection.

*Who* entails the parties involved such as the government entity (auditee), the audit organization (IT department) and audit team. *What* involves the scope of the audit effort

and can include the IT systems and IT processes to be evaluated. *When* is the duration of the audit, including milestone dates for the findings, preliminary results meeting, draft report, final report, exit briefing, and so on. *Where* entails the location(s) of the review. The audit may be conducted at the government entity's headquarters, regional or field offices, data centers, or third-party development centers. *Why* is the reason(s) and explanations why the audit is being conducted, such as to meet legal or other compliance requirements. The entrance briefing is an opportunity for the audit team to gather initial feedback from the government entity's staff to gauge management's philosophy, practices, and goals; information system strengths, weakness, and risks; and interfaces. This information is useful in framing the audit's scope and providing direction on areas requiring more focus and attention.

### ***Data Gathering***

Data gathering should be conducted by the IT audit team to obtain an understanding of the entity being audited. Data gathering includes identifying internal factors, such as the entity's mission, size, locations, organizational structure, and key business processes, and external factors, including applicable legislation affecting the organization, the IT budget, and external system users. The IT data-gathering steps generally begin after the financial audit team has identified material accounts and significant processes related to those accounts. With this input from the financial team, the IT team identifies the applications and support systems that provide the IT backbone for those significant processes. Working with financial audit team, the IT team identifies key automated controls within those significant processes. This understanding of material accounts, significant accounts, and supporting information systems provides the framework for the IT audit activities.

The business processes of an organization support its mission and directly impact the presence of internal controls. The auditor should obtain any information and documentation regarding the entity's business processes, including these:

- Policies
- Procedures
- Manuals
- Plans
- Process flows
- Narratives
- Organizational charts
- Risk assessments
- Service providers
- Changes in the IT environment
- System and application interfaces
- Significant applications and support systems

- Prior work papers
- Prior audit reports

Any risks identified thus far and key business processes related to audit objectives should be noted.

Appendix I of the *FISCAM* contains an information system audit checklist that can be provided to management to facilitate the data-gathering effort during the planning phase.

The auditor should also obtain network documentation to gain an understanding of the entity's network architecture, especially those components that play a role in implementing key business processes. The documentation should cover network components, such as firewalls, routers, switches, intrusion detection and/or prevention systems, servers, connections with external organizations, virtual private networks, and wireless networks.

### ***Identify Critical Processes, Applications, and Systems to Be Audited***

The auditor should identify and prioritize the key items targeted for review (information systems, applications, databases, files, etc.) that support achieving defined audit objectives. For these key items, the auditor should note the locations, previously identified problems, supporting interfaces, and any significant hardware/software components (operating system, hosts, routers, firewalls). To support the identification of critical systems in a financial statement audit, the IT auditor should identify the information systems and key reports utilized to prepare the financial statements and accompanying footnotes.

### ***Identify Risks, Threats, Deficiencies, and Concerns as Part of Risk Assessment***

During the planning phase, the auditor assesses the likelihood that the confidentiality, integrity, or availability of data related to the key areas of interest may be materially/significantly compromised. This preliminary risk assessment affects the nature, timing, and extent of the information system audit procedures. As audit risk increases, the extent of information system controls testing could increase/expand. The auditor can also leverage the entity's risk assessments, but only as a supplement, not as an alternative to the audit team's risk analysis. When analyzing risk, the auditor should determine factors that increase or decrease risk related to confidentiality, integrity, and availability of information and information systems. These factors include inherent and control risk (defined in the next list), management's awareness or interest or lack thereof with regards to information systems security, documented policies defining responsibilities related to IT, and procedures to identify and respond to risks. The audit team should note the nature, extent, and operations affected and any compensating controls for each identified risk.

- *Inherent risk* is the susceptibility of information resources or resources controlled by the information system to material theft, destruction, disclosure, unauthorized modification, or other impairment (before considering related internal controls).

The auditor considers factors that may increase inherent risk, such as types of technology used (e.g., unsupported products, inherently vulnerable technologies, etc.) as well as the characteristics of transactions (e.g., nonroutine transactions, transaction volumes).

- *Control risk* is the risk that a material misstatement in the data will not be prevented or detected and corrected on a timely basis by the entity's internal control structure. To support the assessment of control risk, the auditor considers controls at the entity level, including the control environment, internal risk assessments, information and communication, and monitoring. Other significant areas in the assessment of control risk encompass controls at the data processing level, including management processes and application processes subsystems relative to the applied IT.

### ***Finalize Risk Assessment and Internal Control Evaluations***

The audit test results must be compared to initial audit expectations established at the conclusion of the auditor's earlier evaluation of the system design. Test activities and results must be documented and include: a description of the controls tested, the sampled population, and the relationship of the sample to the overall system; a chronological record of the testing events and people involved; and a summary of test results. The test results will either validate the auditor's earlier preliminary assessment or require the auditor to revise the prior assessment and perhaps the overall audit approach, including planned substantive testing of transactions and accounts.

The effectiveness of an IT-supported system of internal control depends, to a large extent, on the internal control environment in which it operates. Thus, as is the case with any process, the evaluation of the internal control environment significantly influences the auditor's conclusion on the effectiveness of internal controls related to IT. This evaluation is based on observations of actual systems processing, review of documentation, interviews with appropriate personnel, and walk-throughs. The auditor must focus on assessing these areas:

- Management attitude
- Organizational structure
- Personnel
- Delegation and communication of authority
- Policies and procedures
- Budgeting and reporting practices
- Organizational checks and balances applicable to the system

An evaluation of the internal control environment permits the auditor to identify and document the specific risks, threats, and vulnerabilities of the system and its component processes and subprocesses. The auditor must then analyze each process and subprocess from origination of source documents through payment and final disposition in an attempt

to isolate threats and vulnerabilities and to identify mitigating controls and effectiveness of control objectives.

In general, these tasks require the auditor to identify control objectives for each relevant system process or subprocess. In this context, *control objectives* are the desired goals of a specific system process or subprocess. To determine whether control objectives are being met, the auditor performs an iterative evaluation that considers, in turn:

- *Threats* (e.g., events that may prevent achievement of the objective).
- *Vulnerabilities* (e.g., whether internal control techniques are present to mitigate or negate the threat).
- *Overall risk* (e.g., the likelihood that a threat will occur without being prevented by the internal control).

In evaluating risk, the auditor considers four factors:

1. *Efficiency*. Do the applied control techniques achieve desired results within the constraints of cost, benefit, and risk?
2. *Effectiveness*. Do the applied control techniques fulfill the desired control objectives, provide the desired coverage, and operate at appropriate times?
3. *Comprehensiveness*. Are applied control techniques organized and arranged in the proper sequence to ensure achievement of control objectives? Can or should other control techniques be used to reduce risk?
4. *Consistency*. Are applied control techniques uniformly efficient, effective, and comprehensively practiced over extended periods of time?

If these risk assessments identify systems weaknesses, these conditions must be reported to agency personnel and become the focus of a test plan for actual confirmation of the applied controls environment.

### ***Identify Critical Access Points***

This part of the planning phase entails identifying access points that could potentially allow the confidentiality, integrity, or availability of information/data within the system(s), application(s), or database to be compromised. These critical access points typically entail any direct interfaces with the system, application, database, or device being tested or external interfaces to the entity's network and include firewalls, wireless access points (WAPs), Web applications, storage devices such as storage area networks (SANs), and administrative workstations.

### ***Develop Initial Understanding of Information System Controls***

The audit team should obtain information as to the design and effectiveness of relevant general and business process application controls. In addition, during this task, the auditor will obtain documentation on:



- Third-party IT reviews or audits, such as vulnerability scan results and penetration tests.
- Prior years' findings.
- Corrective action plans to remediate information system control weaknesses.
- Disaster recovery and business continuity plans.
- Security management plan.
- Risk assessments for systems or applications to be tested.
- Recent critical security incidents.
- Documentation related to service providers.
- Audit, inspection, and other review reports (e.g., SSAE 16, FISMA, Inspectors General [IGs], GAO, internal, etc.).

The auditor examines this documentation to develop an understanding of the internal control environment and application systems and to gain the perspective needed to conduct subsequent review activities.

### ***Identify Relevant Legislation, Standards, Methodologies, Guidance***

The audit team should identify all applicable legislation, acts, standards, and guidance applicable to the entity to leverage during the audit. To streamline the process of evaluating control effectiveness and compliance with a diverse collection of relevant requirements, it is useful to develop controls and a compliance requirements test matrix. This matrix should include a synthesis of Federal guidance set forth in laws, regulations, and guidance manuals, including:

- Federal Financial Management Improvement Act of 1996 (FFMIA)
- Federal Managers' Financial Integrity Act of 1982 (FMFIA)
- Federal Information Security Management Act of 2002 (FISMA)
- Federal Information Processing Standards (FIPS) Publication 199, *Standards for Security Categorization of Federal Information and Information Systems*
- FIPS Publication 200, *Minimum Security Requirements for Federal Information and Information Systems*
- OMB circulars (e.g., Circulars A-123, *Management's Responsibility for Internal Control*, A-127, *Financial Management Systems*, and A-130, *Management of Federal Information Resources*)
- Statement on Standards for Attestation Engagements (SSAE) 16
- Privacy Act of 1974
- Clinger-Cohen Act of 1996
- NIST Special Publications
- *FISCAM* Guideline
- *Financial Audit Manual (FAM)*

### ***Develop Audit Plan***

Toward the end of the planning phase, the audit team should develop a written audit/test plan to execute during the testing phase. The audit plan incorporates the results of the planning phase, including audit objectives, scope, and methodology for the information systems review. When drafting the audit plan, it is important to first focus on testing entity-wide and system controls prior to business process application controls, unless the audit objectives specifically entail evaluating the application(s) for control weaknesses. No matter how strong the business process application controls are, if the entity-wide and system controls are weak, application controls potentially can be compromised. Thus, if the audit team does not verify the strength of the entity-wide and general system controls, it may conclude that assessing application controls is not efficient or necessary. Audit team members can tailor the application controls testing based upon their comfort level after they have assessed the entity-wide and system controls.

The objective of the audit planning task is to develop a logical testing approach in order to (1) confirm that the agency's data processes conform to the understanding provided by agency management and data processing personnel (and preliminarily through auditor interviews, reviews of systems manuals, and walk-throughs) and (2) determine whether the designed and implemented controls are, in fact, being applied in practice and that the controls are functioning as intended.

In preparing the plan, the auditor selects control techniques to be tested by analyzing documentation developed in the preceding tasks, with a particular emphasis on perceived or potential system threats, deficiencies, vulnerabilities, and the existence of any compensating or mitigating controls. This analysis serves to identify those controls that significantly contribute to control objectives. The test plan must incorporate the specific types of testing to be performed (i.e., document analyses, observation, interviews), timing and extent of tests to conduct, expected test results, and locations where testing will be performed.

The purpose of the testing task is to confirm or refute whether the auditor's preliminary assessment of internal controls—based on the system(s) design and documentation—is supported by practices performed and executed in the system's actual operations. That is, given the auditor's earlier conclusion that the system appeared to be reliable in concept, design, and description (based on manuals, systems charting, written procedures, staff training, etc.), the auditor must personally conduct independent tests to factually ascertain whether the controls, upon which the earlier audit conclusions were based, are being applied and complied with by agency personnel in the day-to-day operation of the system.

### ***Internal Controls over Financial Reporting***

Internal controls over financial reporting must be considered if the information systems audit is part of a financial audit. Doing this entails assessing the risk of a material

misstatement of the financials, which involves considering the business process, any manual controls, and inquiry results from test work performed by the financial auditors in the internal controls phase of GAO's *FAM*. Per *FAM*, this consideration includes:

- Understanding the information system(s).
- Identifying control objectives.
- Identifying and understanding relevant control activities.
- Determining the nature, extent, and timing of control tests and compliance with FFMIA.
- Performing nonsampling control tests and test compliance with FFMIA.
- Assessing internal controls on a preliminary basis.
- Developing documentation including an audit plan with controls testing procedure.

When an information systems audit entails a financial component, testing incorporates compliance/internal controls testing and substantive testing. Compliance testing is a test of controls and is performed once the key controls have been identified. Substantive testing is a test of details; the amount of testing depends on the level of comfort gained from IT/compliance controls testing.

### ***Develop Project Plan***

It is imperative that a project plan be developed to manage the resources, scheduling, and budget of the audit engagement. Without a project plan, the audit organization runs the risk of under- or overallocating resources, not meeting set deadlines/milestones, and/or going over budget. The project plan should outline the budget, allotted hours, audit team resources, audit engagement schedule, milestones, and deadlines. In addition, the progress of the audit must be continually tracked to ensure it is on or ahead of schedule and either exceeding the budget or operating within the budget. If the audit is behind schedule, typically it is also over budget and is trending to miss deadlines.

### **Phase II—Testing**

The testing phase of the audit entails executing test procedures in evaluating the effectiveness of information systems controls (general and business process applications) relevant to the audit objectives defined in the planning phase. It is accomplished through *inquiry* (conducting interviews), *observation* (conducting walk-throughs), questionnaires, documentation/data requests, *inspection* (examining requested evidence), and assessing the maturity of control areas tested. Subsequently, the assessment results are documented, and notification of findings and recommendations (NFRs) are developed when significant control weaknesses are identified. Under GAO standards, the NFR must include condition, cause, criteria, effect, and recommendation. Although not required by standards, many Offices of Inspector Generals and their auditors also include a brief

preface, called the background section, to introduce the noted weakness. Prior to drafting an NFR, the IT auditor should meet with the auditee to confirm the factual accuracy of the noted weakness(es) and discuss the root cause(s), potential negative effects and possible corrective actions. The IT auditor should also inquire if any compensating controls exist that would mitigate the identified control weakness(es). Typically, such discussions are held during a preliminary results meeting with the government entity to discuss each NFR. This practice eliminates audit surprises and avoids instances where IT auditors develop an NFR only to later learn their facts were incomplete or inaccurate. Such discussions may also reveal the presence of compensating controls, which the IT auditor should consider before proceeding to issue an NFR.

According to GAO's *FISCAM* methodology, the testing phase includes a number of activities, including:

- Understanding the information systems relevant to the audit objectives.
- Determining which information system control techniques are relevant to the audit objectives.
- For relevant information system controls, determining whether the control is suitably designed and operating effectively.
- Identifying potential weaknesses in information system controls.
- Considering compensating controls.

Depending on his or her perceptions of the nature, relative effectiveness, strengths, and weaknesses of the controls, the auditor must independently apply a variety of tests, such as those listed next:

- Inspection of documents
- Review of configuration settings
- Reperformance of calculations
- Utilizing data analysis software to identify data anomalies
- Observation of control activities
- Processing of test data
- Performing vulnerability assessments using specialized test tools

These audit tests must occur must encompass the agency's general and application controls.

### ***Test General Controls***

As appropriate, the auditor applies a variety of techniques to test the *general* controls, including the use of audit software tools. In addition, the auditor determines whether documented policies and procedures providing for effective controls over systems development/enhancement/changes are in place and operating as designed and whether

disaster recovery facilities are routinely tested to ensure availability and effectiveness when needed. To reiterate, general controls encompass these areas:

- Security management
- Access controls
- Segregation of duties
- Configuration management
- Contingency planning

### ***Test Application Controls***

Application controls were discussed previously and entail these areas:

- Application security controls
- Business process controls
- Interface controls
- Data management system controls

The test of *application* controls is directed toward assuring the accuracy of the data processed by the system under review. A key consideration discussed in earlier chapters is adequate segregation of duties. Without adequate segregation of duties, tests of controls must take a backseat to alternate procedures designed to compensate for this weakness. If this is not possible and depending on the nature and potential impact of the application, the auditor may be forced to qualify and even disclaim an opinion. Assuming adequate segregation of duties, tests must be tailored to the characteristics of the application, paying strict attention to the methods of processing used for data origination, input, processing, and output. Test data are constructed to allow the auditor to determine whether the application controls ensure that routine transactions are processed in a timely manner and whether the designed and implemented application controls reject invalid transactions. Testing is also employed to determine if erroneous data are adequately controlled for correction and reentry. Tests of routine, standard, or “normal” transactions are conducted to evaluate the system’s ability to establish, change, and delete records; perform calculations; and test the system’s processing logic.

The objective of data origination controls is to determine the extent to which controls ensure the accuracy, completeness, and timeliness of transactional data and that data automatically proceed through the systems application phases without loss, unauthorized addition or modification, or other errors. The testing approach must also determine the adequacy of controls over the manual preparation, collection, and processing of source documents and must evaluate the effectiveness of procedures and techniques for ensuring that no data are added, lost, or altered before they are entered.

When testing data input controls, the auditor must determine the adequacy of manual and automated controls over data input to ensure accurate entry with optimum use of

computerized validation and editing and also that error-handling procedures facilitate timely and accurate resubmission of corrected data. Thus, the audit focus is on data processing integrity, validation, editing, and error handling. Also of audit significance are those controls implemented and applied over files and systems that interface with the application under review.

Audit tests of data output are applied to ensure that products of the data processing results are accurate and reports are distributed to users in a timely manner. The audit test focus for output controls includes data output balancing and reconciliation, output distribution, output error handling, and handling and retention of output records and accountability (e.g., audit trails) of documents.

### ***Documentation During Testing Phase***

The audit team should ensure thorough and organized documentation is developed and maintained during the testing phase. Documentation may include those listed next:

- Understanding of the systems, applications, databases, and any key interests related to the audit objectives, documented in flow charts, diagrams or narratives within the work papers
- Assessment steps performed for evaluating the items tested and the outcome
- Method of testing for each control (inquiry, observation, inspection) and evidence received
- Identified information system control weaknesses and whether compensating controls exist to mitigate the deficiencies
- Whether the identified observations are significant or material in nature and what the impact is for each finding
- Conclusion reached regarding the effectiveness of the general and application controls

### **Phase III—Reporting**

In the context of a financial statement audit, *Government Auditing Standards* (the Yellow Book) and OMB circulars and bulletins require the auditor to report findings in the auditor's report on internal control and on compliance with laws and regulations. Whether issued jointly as a single report or separately, the auditor must describe the scope of audit tests employed and the results of those tests and provide an audit opinion or other type of audit assurances.

During the reporting phase, the auditor reviews the prior evaluation and testing efforts and identifies:

- Reportable conditions and material weaknesses to be included in the report on internal controls.

- Events of noncompliance with Federal guidance that need to be reported in the auditor's report on compliance with laws and regulations.
- Other internal control matters and opportunities for improved efficiency that the auditor concludes should be included in the management letter (and/or reported informally to appropriate levels of Federal Agency management).

This phase entails completing a draft report and providing it to the government entity for comment. Prior to receiving written comments from the auditee, industry practice is for the audit team to meet with the auditee to provide an overview of the report and findings noted. While this meeting is not required by standards, the meeting provides auditee management a chance to ask questions and clarify points made within the draft report. The IT audit team then evaluates the management response to the draft report and incorporates suggestions and feedback into the final report. Both the draft report and the final report should cross-reference back to the supporting audit work papers to confirm that all facts and figures are accurate and supported by sufficient and appropriate evidence. Last, the IT audit team conducts a formal exit briefing with auditee management to conclude the audit. The exit briefing provides an overview of the audit review, presents the scope of the overall assessment, and explains final conclusions reached.

## **UNDERSTANDING KEY LAWS AND REGULATIONS ON INFORMATION SECURITY**

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Due to potential information security risks and threats, laws, regulations, standards, and guidance exist in the Federal sector requiring Federal Agencies and their contractors to take action in the area of information security and privacy. Experienced Federal security auditors refer to this as a forest of guidance that can be overwhelming for auditors new to the Federal market space. The objectives of this section are to simplify this forest of IT security regulations and provide a concise, clear path for experienced IT auditors to develop and successfully execute an IT audit, reviews, or attestation engagement in the Federal space.

IT auditors must understand the various Federal laws, OMB policies, and regulations that may affect their audit, review, or attestation engagement. Here we provide a brief overview of the most significant Federal laws, OMB policies, and regulations organized in chronological order, as each law or regulation builds upon prior guidance. Exhibit 13.2 provides an overview of the various Federal criteria an IT auditor must be familiar with when supporting Federal financial statement audits, performing FISMA audits or reviews, privacy audits, or preparing for SSAE 16, service organization control (SOC) reports for Federal entities.

<b>EXHIBIT 13.2 Mapping Federal Audit Criteria to Audits of Federal Entities</b>
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<i>Laws, Regulations, and Guidance</i>	<i>IT Support of a Financial Statement Audit</i>	<i>FISMA Performance Audit Under GAO Yellow Book</i>	<i>FISMA Evaluation Under CIGIE Standards</i>	<i>Privacy Audit</i>	<i>SSAE 16 SOC I Engagement</i>
Clinger-Cohen Act of 1996	•	•	•	•	•
E-Government Act of 2002	•	•	•	•	•
Federal Information Security Management Act (FISMA)	•	•	•		
Federal Information Process Standards (FIPS) Publication (PUB) 199, <i>Standards for Security Categorization of Federal Information and Information Systems</i>	•	•	•	•	•
FIPS PUB 200, <i>Minimum Security Requirements for Federal Information and Information Systems</i>	•	•	•	•	•
OMB Circular A-130, <i>Appendices I and III, Management of Federal Information Resources</i>	•	•		•	
OMB Circular A-127, <i>Financial Management Systems</i>	•				
FFMIA & FMFIA	•				
OMB Memorandum M-03-22				•	
Privacy Act of 1974				•	
Section 208 of the E-Government Act				•	
Section 522 in the Consolidated Appropriations Act of 2005				•	
GAO's Financial Audit Manual (FAM)	•				
GAO's Federal Information System Controls Audit Manual (FISCAM)	•				
GAO <i>Government Auditing Standards</i> (Yellow Book)	•	•			
Statement on Standards for Attestation Engagements (SSAE) 16, <i>Reporting on Controls at a Service Organization</i>	•	•	•	•	•
NIST Special Publications	•	•	•	•	•

### Significant Federal Legislation

Part of planning any financial or IT audit is understanding the relevant laws and regulations that a Federal Agency must comply with. Under GAO Yellow Book guidance, auditors must disclose any noted instances where a Federal Agency violated established laws and regulations relevant to their audit objectives. Within the scope of most Federal IT audits are two significant laws—the Clinger-Cohen Act of 1996 and the FISMA (Title III of the E-Government Act). These two laws are discussed below. Privacy and the protection of personally identifiable information (PII) are covered later in the chapter as specialty areas within the IT auditing field.



### ***Clinger-Cohen Act of 1996***

The Clinger-Cohen Act of 1996 encompassed both the Information Technology Management Reform Act (ITMRA) and the Federal Acquisition Reform Act (FARA). It established the role of chief information officer (CIO) at Federal Agencies and tasked the CIO with advising agency heads regarding IT acquisitions and management of IT resources; monitoring and evaluating the performance of IT programs; and determining whether to continue, modify, or terminate specific agency IT projects and programs.

The act also assigns responsibilities to the Director of OMB. The responsibilities include overseeing the development and implementation of standards for Federal information systems through the NIST while also promoting best practices for IT purchases and improving how IT is used and disposed of by the executive branch agencies of the Federal Government. Clinger-Cohen tasked the director of OMB to compare the executive agencies' performance in using IT and provide the results to the agency heads. The director of OMB was also required to monitor the development and implementation of executive agency training programs related to the management of information resources. Finally, Clinger-Cohen required the director of OMB to report the status and improvement of executive agency IT programs and management of information resources to Congress.

### ***E-Government Act of 2002***

Congress passed the E-Government Act of 2002, which "recognized the importance of information security to the economic and national security interests of the United States." The scope of the E-Government Act is very broad and includes a number of provisions to encourage electronic government services and cooperation among Federal Agencies. One important provision of the act is the establishment of a Federal CIO within OMB. The E-Government Act also assigned specific responsibilities to Federal CIOs and NIST for establishing information security and privacy policy and guidance across the Federal Government. Perhaps the most important provisions of the E-Government Act related to Title III of the act, referred to as FISMA. FISMA replaced the Government Information Security Reform Act (GISRA), passed in 2000, and repealed the Computer Security Act of 1987.

### ***FISMA***

FISMA requires each Federal Agency to establish an agency-wide information security program to protect the information and information systems that support the operations and assets of the agency, including those provided or managed by a contractor or other agency. FISMA requires agency IGs or an external auditor as determined by the IG to conduct an annual evaluation of the agency's information security program and report the results to OMB. OMB uses this information to execute its oversight responsibilities in preparing an annual report to Congress regarding agency compliance with FISMA.

As a result of the FISMA legislation, Congress assigned NIST specific responsibilities, including the development of information security standards and guidance for agency information security systems, excluding national security systems. NIST released two key publications: FIPS PUB 199 and FIPS PUB 200, plus various 800-series special publications (SPs). These key publications form the basis of an information security program as described in the FISMA legislation.

FIPS PUB 199, issued February 2004, is a mandatory security standard that addresses categorizing Federal Agency information and information systems based on the *impact of loss* regarding confidentiality, integrity, and availability of the information or information system in contrast to other information security models, which attempt to assign arbitrary values to information types. FIPS PUB 199 defines confidentiality, integrity, and availability as security objectives when applying an impact risk rating of high, moderate, or low during the assessment of information and information systems.

When categorizing an information system, information types, such as salary and Social Security numbers (SSNs) are defined and evaluated against the loss of confidentiality, integrity, and availability. The highest impact of each information type (related to confidentiality, integrity, and availability) is noted. Subsequently, the information system is given an overall security categorization (high, moderate, or low). This concept is known as the high-water mark and is employed to select the minimum baseline security controls.

With regard to the *confidentiality* control objective, a low impact is assigned if the unauthorized disclosure of information could be expected to have a *limited* adverse effect on organizational operations, organizational assets, or individuals. A *moderate* impact is given if the adverse effect is *serious*, and a *high* impact is designated if the adverse effect is *severe or catastrophic*.

Similarly, in terms of the *integrity* control objective, a *low* impact is assigned if the unauthorized modification or destruction of information could be expected to have a *limited* adverse effect on organizational operations, organizational assets, or individuals. A *moderate* impact is given if the adverse effect is *serious*, and a *high* impact is designated if the adverse effect is *severe or catastrophic*.

Finally, for an *availability* control objective, a *low* impact is assigned if the disruption of access to or use of information or an information system could be expected to have a *limited* adverse effect on organizational operations, organizational assets, or individuals. A *moderate* impact is given if the adverse effect is *serious*, and a *high* impact is designated if the adverse effect is *severe or catastrophic*.

These concepts of low, moderate, and high impact are applied to information types and categories within a given information system. Exhibit 13.3 provides an example of one agency's categorization of its integrated human resources (HR)–payroll information system. Using the definitions provided in FIPS PUB 199 and information categorization from NIST SP 800-60 Review 1, *Guide for Mapping Types of Information and Information Systems*

<b>EXHIBIT 13.3 Security Categorization of HR-Pay Application</b>
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<i>Description</i>			<i>Sensitivity (H, M, L)</i>				<i>Highest Impact</i>
<i>Application Name</i>	<i>Short Name</i>	<i>Classification</i>	<i>Information Category</i>	<i>Confidentiality</i>	<i>Integrity</i>	<i>Availability</i>	
HR-Pay	HR/Payroll	SBU	Income Information	M	M	M	<b>M</b>
			PII—Names	L	L	L	<b>L</b>
			PII—Account #s	L	L	L	<b>L</b>
			PII—SSN	L	L	L	<b>L</b>
			PII—Address	L	L	L	<b>L</b>
			PII—More than One Item of Any PII Information for an Individual	M	M	M	<b>M</b>
			PII—Substantive Individual Family Info	M	M	M	<b>M</b>
			General Retirement and Disability	M	M	M	<b>M</b>
			Highest Impact	M	M	M	<b>M</b>
<b>Overall System Security Categorization</b>							<b>M</b>

to *Security Categories*, the Federal Agency prepared this analysis to determine the high-water mark.

As a companion to FIPS PUB 199, NIST published FIPS PUB 200 in March 2006. This Federal standard requires Federal Agencies to employ a minimum level of security controls for their information systems. For Federal information or information systems categorized as low impact, agencies must employ at least the low baseline security controls as defined in NIST SP 800-53, *Recommended Security Controls for Federal Information Systems and Organizations*. For Federal information or information systems labeled as moderate impact, agencies must employ at least the moderate baseline security controls as defined in NIST SP 800-53. Finally, for Federal information or information systems labeled as high impact, agencies must employ at least the high baseline security controls as defined in NIST SP 800-53.

FIPS PUB 200 is the second of the two mandatory security standard required by the FISMA legislation and sets the minimum level of security required for an information system. NIST released SP 800-53 to provide guidance on the application of security controls in compliance with FIPS PUB 200. FIPS PUB 200 mandates the use of NIST SP 800-53 and promotes more secure Federal Agency information systems by establishing security baseline requirements to protect the confidentiality, integrity, and availability of

<b>EXHIBIT 13.4 NIST Security Areas</b>		
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<i>ID</i>	<i>Family</i>	<i>Class<sup>c</sup></i>
AC	Access Control	Technical
AT	Awareness and Training	Operational
AU	Audit and Accountability	Technical
CA	Security Assessment and Authorization <sup>a</sup>	Management
CM	Configuration Management	Operational
CP	Contingency Planning	Operational
IA	Identification and Authentication	Technical
IR	Incident Response	Operational
MA	Maintenance	Operational
MP	Media Protection	Operational
PE	Physical and Environmental Protection	Operational
PL	Planning Management	Management
PS	Personnel Security	Operational
RA	Risk Assessment	Management
SA	System and Services Acquisition	Management
SC	System and Communications Protection	Technical
SI	System and Information Integrity	Operational
PM	Program Management <sup>b</sup>	Management

<sup>a</sup>The area of “certification, accreditation and security assessments” in FIPS PUB 200 is labeled as “security assessment and authorization” in NIST SP 800-53.

<sup>b</sup>NIST SP 800-53 includes an additional family (program management) not captured in FIPS PUB 200. It provides controls at the organizational level as opposed to the information system level.

<sup>c</sup>Each of the security-related areas address either technical, operational, or management aspects of protecting Federal Agency information and information systems.

agency information systems, including the information processed and stored by the systems. The requirements cover 17 security related areas summarized in the FIPS PUB 200 publication and detailed further in NIST SP 800-53. The security areas are identified in Exhibit 13.4.

### **OMB Circulars**

OMB issues various circulars to executive agencies, some of which pertain to information security and internal controls. They include OMB Circular A-123, *Managements Responsibility for Internal Control*, OMB Circular A-127, *Managing the Financial Management Systems*, and OMB Circular A-130, Appendix III, *Security of Federal Automated Information Resources* (referred to as Appendix III). Appendix III provides the foundational requirement for Federal Agencies to develop information security plans as well as to periodically assess information security controls at least every three years. Federal IT auditors should be well versed in Appendix III as it provides foundational policy statements that are included throughout FIPS publications and NIST SPs.

- *Circular A-123.* OMB Circular A-123 was issued in December 2004 and is the Federal equivalent to the Sarbanes-Oxley Act of 2002, which applies only to publicly traded companies. OMB Circular A-123 was formulated to achieve Federal program accountability and effectiveness by defining management's responsibility for internal financial controls in Federal Agencies. Earlier chapters presented a more detailed discussion of A-123.
- *Circular A-127.* OMB Circular A-127 provides policies and guidance on managing executive branch financial management systems and entails compliance with FFMIA. FFMIA requires that Federal Agency financial systems provide accurate, reliable, and timely financial data in accordance with generally accepted accounting principles (GAAP). Agencies covered by the Chief Financial Officers (CFO) Act of 1990 are required per Section 803(a) of OMB Circular A-127 to comply with FFMIA Section 803(a) requirements. Agencies not covered under the CFO Act are encouraged to comply with FFMIA requirements but are not required to.

OMB Circular A-127 previously required the use of commercial off-the-shelf systems (COTS) that were certified by the Financial Systems Integration Office (FSIO); however, FSIO was closed in March 2010. Subsequently, on June 28, 2010, OMB issued Memorandum M-10-26, *Immediate Review of Financial Systems IT Projects*, which stated that the current "Core Financial System" requirements set forth in OMB Circular A-127 remained in effect but that the FSIO certification process was terminated and, therefore, OMB had shifted the accountability for software performance to the vendor through self-certification. In addition, OMB stated that a revision to OMB Circular A-127 would be issued to update existing requirements and include new guidance on how agencies and auditors would evaluate compliance with these requirements. OMB Circular A-127 defines a core financial system as "an information system that may perform all financial functions including general ledger management, funds management, payment management, receivable management, and cost management."

OMB Memorandum M-10-26 provided the reasoning as to why the financial software certification was discontinued:

The Financial Systems Integration Office (FSIO) previously required a formal test procedure of financial software as part of a certification program that confirmed the products contained the functionality required by issued system standard requirements. This process was established at a time when problems with software functionality posed a significant risk to system performance. Over time, this risk has diminished. In addition, the FSIO software certification process was lengthy and resource intensive, delaying the procurement process for software by 18 months and creating significant costs for the software vendor that were passed back to the

taxpayer. This process was terminated by OMB in March 2010 because it did not align well with our objectives to deploy newer, cost-effective technologies more timely. In addition, the certification program still resulted in products that did not have some required functionality, despite the testing.

Section 803(a) of OMB Circular A-127 includes three requirements to Federal financial systems. The first entails *computer security requirements*, which entail computer security control requirements set forth in FISMA legislation and OMB Circular A-130. The second consists of the *internal controls* requirements entailing the internal control objectives set forth in OMB Circular A-123, which OMB Circular A-127 states is to “[e]nsure resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and disclosed in reports.” The third requirement for Federal financial systems is to comply with the *FSIO Core Financial System Requirements*.<sup>3</sup>

- *Appendix III*. IT auditors should pay close attention to OMB A-130 Appendix III, as it provides the foundational concepts for NIST SP 800-37 Rev 1, *Guide for Applying the Risk Management Framework to Federal Information Systems: A Security Life Cycle Approach*, and SP 800-53 Rev 3, *Recommended Security Controls for Federal Information Systems and Organizations*, and defines several key words, such as *general support system* and *major application*. Appendix III is used in conjunction with NIST SP 800-53 to provide guidance on minimum security requirements for Federal information systems. It requires agencies to develop and implement a security program to protect all information collected, processed, transmitted, stored, or dispersed in systems and major applications. It defines controls for general support systems and major applications, such as assigning an individual responsible for the security of the system or application, and developing a security plan for each system or application that provides implementation details for each of the 18 security control areas in NIST SP 800-53 Rev 3.<sup>4</sup>

Of particular significance to IT auditors, Appendix III requires all IT security controls outlined in a system’s security plan to be tested at least every three years. These reviews were previously called *Certification and Accreditation (C&A)*. Given

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<sup>3</sup> When assessing OMB A-127 compliance, IT auditors may wish to leverage GAO’s checklist of *FSIO Core Financial System Requirements*. This publication, *Core Financial System Requirements, Checklist for Reviewing Systems under the Federal Financial Management Improvement Act*, dated February 2005, can be found on GAO’s Web site, [www.gao.gov](http://www.gao.gov).

<sup>4</sup> NIST continually updates its Special Publications. IT auditors should refer to the latest guidance in Special Publications found on NIST’s Computer Security Research Center at <http://src.nist.gov/publications/PubsSPs.html>.

the significant time between security assessments, NIST revised its methodology for authorizing information systems to operate to require more frequent assessments of security controls based on the control's risk and volatility (manual versus automated). The concept of C&A is now referred to as *Security Assessment and Authorization* (SAA) in the latest revision of NIST SP 800-53 Rev 4 and NIST SP 800-37 Rev 1. NIST SP 800-37 Rev 1 defines a six-step process where the last process step focuses on continually monitoring information systems to ensure that associated security risks are mitigated.

OMB now requires a continuous approach to monitoring information systems and applications, effectively fulfilling the three-year information systems reauthorization requirement in Appendix III. Therefore, SSA for an individual information system is no longer required every three years under the premise that agency management is assessing security controls on a weekly, monthly and/or annual basis. *Authorization*, also referred to as *accreditation*, refers to a management official factoring the results of the system or application control review in determining whether to authorize (in writing) the use of the system or application and consequently accept the risks associated with it. As stated, continuous monitoring of information systems security in effect entails continuous security authorization of information systems and thus removes the formality of creating an "authorization to operate" letter every three years.

As mentioned previously, Appendix III establishes several important definitions that are subsequently used throughout NIST special publications. Appendix III defines general support systems as

an interconnected set of information resources under the same direct management control which shares common functionality. A system normally includes hardware, software, information, data, applications, communications, and people. A system can be, for example, a local area network (LAN) including smart terminals that supports a branch office, an agency-wide backbone, a communications network, a departmental data processing center including its operating system and utilities, a tactical radio network, or a shared information processing service organization (IPSO).

Appendix III defines major applications as

an application that requires special attention to security due to the risk and magnitude of the harm resulting from the loss, misuse, or unauthorized access to or modification of the information in the application.

OMB directs agencies to leverage NIST SP 800-37 Rev 1 and NIST SP 800-137, *Information Security Continuous Monitoring for Federal Information Systems and Organizations*, for continuous monitoring efforts. In addition, as part of

continuous monitoring, agencies are required to report the security posture of their information systems via automated monthly data feeds through the Federal CyberScope application rather than by paper or e-mail. CyberScope was co-developed by the Department of Homeland Security (DHS) and Department of Justice to provide OMB and DHS the ability to collect and report on the cyber-security posture of executive branch agencies.

### ***FFMIA and FMFIA***

FISMA and OMB Circulars A-123, A-127, and A-130 support the FFMIA of 1996 and the FMFIA of 1982. As mentioned in section on OMB Circular A-127, FFMIA requires that Federal Agency financial systems provide accurate, reliable, and timely financial data in accordance with GAAP. FMFIA requires agencies to establish internal controls over financial systems and provide an annual assurance statement regarding the adequacy of their systems, including whether they produce reliable financial data.

The current FFMIA approach in terms of Federal requirements for financial systems is evolving from a very detailed requirements approach toward a high-level, conceptual framework. OMB believes the changes will entail solutions that are shorter term, less costly, and easier to implement and manage.

## **PRIVACY AND THE EXPANDED REQUIREMENTS IN FEDERAL IT AUDITS**

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IT auditors need to be increasingly aware of U.S. citizens' privacy, particularly when the Federal Government collects such information to fulfill their agency's mission. Since the passage of the Privacy Act in 1974 and the E-Government Act of 2002, there has been significant increase in the collection and disclosure requirements placed on all Federal Agencies. These laws and requirements have manifested themselves in multiple OMB memorandums and new information security publications from NIST, most recently with the release of NIST SP 800-53 Rev. 4, which dedicates Appendix J, *Privacy Control Catalog*, to the discussion of privacy controls and considerations. This discussion of privacy presents the most significant privacy laws and OMB memoranda that IT auditors should know as they plan IT audits and reviews of information systems that process PII.

### **Privacy Acts and Guidance**

When the public provides the government with personal and sensitive information, it trusts that the government appropriately secures this information and protects it from unauthorized disclosure or modification, whether it is stored in paper format or electronically in information systems.



### ***Privacy Act of 1974***

Often, certain events trigger initiatives to mitigate those or similar events from recurring. In the context of information privacy and disclosure, one historical event played a role in privacy and disclosure legislation. The Watergate scandal exposed the government's illegal surveillance and investigation of innocent individuals for political motives. In response to the many abuses of individual privacy by the Nixon administration and the use of secret Federal Bureau of Investigation (FBI) files and wiretaps for political gain, Congress passed the Privacy Act of 1974.

Broadly stated, the purpose of the Privacy Act is to balance the government's need to maintain information about individuals with the rights of individuals to be protected against unwarranted invasions of their privacy stemming from Federal Agencies' collection, maintenance, use, and disclosure of personal information about them. The Act focuses on four basic policy objectives:

1. To restrict disclosure of personally identifiable records maintained by agencies.
2. To grant individuals increased rights of access to agency records maintained on them.
3. To grant individuals the right to seek amendment of agency records maintained on themselves upon a showing that the records are not accurate, relevant, timely, or complete.
4. To establish a code of "fair information practices," which requires agencies to comply with statutory norms for collection, maintenance, and dissemination of records.<sup>5</sup>

The intent of the Privacy Act of 1974 was also to establish and promote transparency of government and disclose the collection of personally identifiable information by publishing a formal notice in the *Federal Register*. The Privacy Act of 1974 mandates the publishing of system of records notices (SORNs) for newly created and revised systems of records. The Privacy Act defines a *system of records* as "a group of any records under the control of any agency from which information is retrieved by the name of the individual or by some identifying number, symbol, or other identifying particular assigned to the individual." A system of records entails both paper and electronic records and information. When a system of records is created or modified, a SORN must be provided to OMB and Congress and be published in the *Federal Register* before the system is made operational. SORNs act as legal notices to the public. If public officials fail to publish a SORN when required by law to do so or improperly disclose personal information to a third party, the Federal Agency and the public official may be subject to a \$1,000 penalty under certain circumstances.

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<sup>5</sup> Department of Justice, *Overview of the Privacy Act of 1974*, 2010 edition.

This concept of transparency and disclosure of a system of records led to the inclusion of Section 208 of the E-Government Act of 2002. Section 208 extends the disclosure requirement found in the Privacy Act to require that all Federal Agencies conduct a privacy impact assessment (PIA) for all new or substantially changed technology that collects, maintains, or disseminates PII, or for a new collection of information that is collected, maintained, or disseminated using IT. A PIA is a process for:

- Examining the risks and ramifications of using IT to collect, maintain, and disseminate PII from or about members of the public.
- Identifying and evaluating protections and alternative processes to mitigate the impact to privacy of collecting such information.

OMB Memorandum M-03-22, *OMB Guidance for Implementing the Privacy Provisions of the E-Government Act of 2002*, provides implementation guidance for the Section 208 legislation and guides agencies in regard to what must be included and posted publicly in PIAs. According to OMB Memorandum M-03-22, PIAs must analyze and describe:

1. What information is to be collected.
2. Why the information is being collected.
3. Intended use of the information.
4. With whom the information will be shared.
5. What opportunities individuals have to decline to provide information or to consent to particular uses of the information and how individuals can grant consent.
6. How the information will be secured.
7. Whether a system of records is being created under the Privacy Act, §5 United States Code (U.S.C.) 552a.
8. What choices the agency made regarding an IT system or collection of information as a result of performing the PIA.

### ***Section 522 of Division H of the Consolidated Appropriations Act of 2005***

Section 522 of the Consolidated Appropriations Act of 2005, recodified to 42 U.S.C. § 2000ee-2, is the most recent addition to the privacy statutory landscape that governs the privacy practices of Federal Agencies. This legislation expands on the foundation and framework laid by the Privacy Act and the E-Government Act by instituting programmatic level requirements and reenforcing the provisions of prior legislation. The passage of Section 522 in 2005 and then its recodification to 42 U.S.C. § 2000ee-2<sup>6</sup> established the legal requirement that Federal Agencies implement formal privacy programs. Prior to the passage of Section 522, many Federal Agencies divided implementation responsibilities

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<sup>6</sup> The full text of 42 U.S.C. § 2000ee-2 is available at <http://uscode.house.gov/download/pls/42C21E.txt>.

for the Privacy Act and Section 208 of the E-Government Act with varying degrees of success. Congress recognized the need for agencies to unify disparate activities under a single Privacy Program to improve efficiency and effectiveness; thus it established the Privacy Program requirements in Section 522.

Section 522 requires the agency's chief privacy officer (CPO) to have primary responsibility for agency privacy and data protection policies. As part of that responsibility, the CPO must assure that the agency's use of technology sustains privacy protections. In accordance with Section 522, each Federal Agency's CPO must also prepare an annual report to Congress on the activities that affect privacy, including complaints of privacy violations, and implementation of related internal controls. In practice, agency CPOs prepare and submit responses to OMB's privacy questions as part of the agency's FISMA report to OMB and the Congress using the CyberScope tool hosted by DHS. This annual submission satisfies Section 522 reporting requirements.

Section 522 legislation also contains requirements for agency IGs to biannually conduct reviews of agency compliance with the Privacy Act of 1974, Section 208 of the E-Government Act of 2002, and OMB privacy guidance. Section 522 requires IGs to make their privacy reviews public and transmit results on agency Privacy Programs to the Committees on Appropriations of the House of Representatives and the Senate, the House Committee on Oversight and Government Reform, and the Senate Committee on Homeland Security and Governmental Affairs. When Congress recodified the Section 522 legislation as 42 U.S.C. § 2000ee-2, the biannual review requirement of the privacy program was changed to an annual review. The recodified legislation also permits agency IGs to consolidate the annual Privacy Program review with their annual information security review under FISMA legislation. In practice, nearly all agency IGs submit one combined report on their agency's Privacy and Information Security program to OMB, DHS, and Congress. Since most FISMA reports contain sensitive, nonpublic information, these combined reports are not publicly available and thus defeat the original intent of Section 522 legislation to highlight an agency's compliance or instances of noncompliance. Nevertheless, the presence of the FISMA legislation and Section 522 legislation has created demand and market opportunities for IT professionals knowledgeable of Federal IT security and privacy requirements.

### **OMB Circulars and Memoranda on Privacy**

To support the implementation of the Privacy Act, Section 208, and Section 522/42 U.S.C. § 2000ee-2 legislation, OMB has released numerous circulars and memoranda on privacy. This section presents a short summary of the most significant OMB memoranda discussing privacy that IT audit professionals should know. Many of these privacy memoranda are also significant to the agency's CPO, CIO, and Office of General Council as they provide important legal definitions for key privacy terms and assign specific responsibilities to individuals fulfilling these agency functions.

**OMB Circular A-130, Appendix I**

OMB Circular A-130, *Management of Federal Information Resources*, Appendix I, *Federal Agency Responsibilities for Maintaining Records about Individuals*, requires the heads of all Federal Agencies to ensure reviews are conducted at their agency to confirm Privacy Act compliance. These reviews include, among other things, record-keeping practices, routine use disclosures, privacy act training, and violations.

**OMB Memorandum M-03-22**

OMB Memorandum M-03-22 defines *information in an identifiable form* (IIF) as information in an information system or an online collection that directly identifies an individual (e.g., name, address, SSN, or other identifying code, telephone number, e-mail address, etc.) or by which an agency intends to identify specific individuals in conjunction with other data elements.

**OMB Memorandum M-06-19**

OMB Memorandum M-06-19, *Reporting Incidents Involving Personally Identifiable Information and Incorporating the Cost for Security in Agency Information Technology Investments*, issued July 12, 2006, introduces the term *PII* as a replacement for *IIF*. This book uses the term *PII* to be consistent with more recent OMB memoranda, such as OMB Memorandum M-07-16, *Safeguarding Against and Responding to the Breach of Personally Identifiable Information*, issued May 22, 2007, and NIST guidance.

**OMB Memorandum M-06-16**

OMB Memorandum M-06-16, *Protection of Sensitive Agency Information*, issued June 23, 2006, establishes four requirements. First, it requires all executive departments and agencies to encrypt all data on mobile computers that contain agency data unless the data are determined to be nonsensitive in writing by the agency deputy secretary. Second, the memo also requires two-factor authentication for remote access. Third, it requires an automated 30-minute time-out function for inactive remote sessions, and, fourth, it requires the logging of all data extracts of PII data. Of particular note to IT auditors, these four requirements have become mandatory, minimum security requirements for moderate impact systems in subsequent revisions to NIST SP 800-53 Rev 2.

**OMB Memorandum M-06-19**

OMB Memorandum M-06-19, *Reporting Incidents Involving Personally Identifiable Information and Incorporating the Cost for Security in Agency Information Technology Investments*, entails the reporting of security incidents and as such requires agencies to report all incidents involving PII to the United States Computer Emergency Readiness Team (US-CERT) within one hour of learning of the incident.

**OMB Memorandum M-07-16**

OMB Memorandum M-07-16 requires agencies to develop and enforce a breach of PII notification policy and provides guidance for doing so.

**OMB Memorandum Recommendations for Identity Theft Related Data Breach Notification**

OMB Memorandum, *Recommendations for Identity Theft Related Data Breach Notification*, issued September 20, 2006, requires agencies to establish a core management group responsible for responding to the loss of personal information.

**Methodologies and Standards**

This section describes the key IT audit methodologies in the Federal sector. As discussed, many laws, regulations, and acts have been developed to ensure the confidentiality, integrity, and availability of information and information systems. In addition, methodologies and standards have been created to promote and evaluate compliance with legislation and acts within the Federal sector. They include GAO's Yellow Book, *FISCAM*, and *FAM*. Increasingly Federal entities are leveraging shared IT service providers and requesting attestation reports on internal controls. SSAE 16 from the American Institute of Certified Public Accountants (AICPA) provides a framework for reporting on internal controls at service organizations. To provide guidance to agency IGs beyond audits, the Council of the Inspectors General on Integrity and Efficiency (CIGIE) issued the *Quality Standards for Inspection and Evaluation* in January 2012 for conducting inspections and evaluations of Federal Agency policies, programs, and operations.

**FAM**

*FAM* describes in detail the auditor's responsibilities for considering internal control in a financial audit. *FAM* provides guidance in performing financial statement audits of Federal Agencies in accordance with professional standards. Volume 1 provides an audit methodology, Volume 2 presents audit tools, and Volume 3 includes checklists for accounting, reporting, and disclosure.

The *FAM* methodology for performing financial statement audits consists of the planning, internal control, testing, and reporting phases. *FISCAM*, which is presented as a companion guide to *FAM*, outlines three phases (planning, testing, and reporting) for performing information system audits of Federal systems. If the information system audit is performed as part of a financial statement audit, government auditing standards (GAS) requires auditors to gain an understanding of internal control over financial reporting to determine the risk of a material misstatement of the financial statements. Guidance for the internal control component is contained in *FAM*'s internal control phase.

<b>EXHIBIT 13.5 FISCAM Control Areas</b>	
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<i>General Controls</i>	<i>Business Process Application Controls</i>
Security Management	Application Security*
Access Controls	Business Process
Configuration Management	Interface
Segregation of Duties	Data Management System
Contingency Planning	

\*Application Security refers to General Controls operating at the business process application level.

### **FISCAM**

*FISCAM* is a methodology for performing information system audits of Federal entities and is designed to support financial audits performed in accordance with GAO's *Government Auditing Standards*. It encompasses both general IT controls (security management, access controls, configuration management, segregation of duties [SoD], and contingency planning) and business process application controls (application security controls, business process controls, interface controls, and data management system controls) as referenced in Exhibit 13.5. General controls operate at the entity-wide and system level (network, operating system, and infrastructure applications) whereas business process application controls operate at the business process application level.

It is important to understand that no matter how strong the business process application controls are, if the entity-wide and system controls are weak, application controls can potentially be compromised. This is why organizations should begin strengthening the entity-wide and system-level controls and then focus on the application controls.

In the following paragraphs, we provide a brief overview of the five general and application control areas within *FISCAM*. IT auditors should be sufficiently familiar with these security concepts to apply them on Federal financial statement audits.

1. *Security Management*. Security management entails employing an entity-wide information security management program, which is the foundation of a security control structure and reflection of senior management's commitment to addressing security risks. The security management program should establish a framework and continuous cycle of activity for assessing risk, developing and implementing effective security procedures, and monitoring the effectiveness of these procedures. Overall policies and plans are developed at the entity-wide level. System and application-specific procedures and controls implement the entity-wide policy. FISMA requires that a security management program be in place for Federal Agencies.
2. *Access Controls*. Access controls limit or detect inappropriate access to computer resources (data, equipment, and facilities), thereby protecting them from

unauthorized modification, loss, and disclosure. Logical access controls require users to authenticate themselves and limit the files and other resources that authenticated users can access and the actions they can execute. Without adequate access controls, unauthorized individuals, including external threats and former employees, may access sensitive data and make undetected changes or deletions for malicious purposes or personal gain.

*Identification, authentication, authorization, and accountability* are concepts related to access control. Identification entails an individual's name or username. To prove identify when accessing a system, a password is required, which supports authentication. Once authenticated, individuals should have specific authorizations set up depending on what they can access within the system and to what ability (i.e., read, write, execute). Accountability entails enabling logging on the system to log system activity and hold users accountable for their actions within the system. It is important to ensure all four access control concepts are enforced on systems to promote information security.

3. *Configuration Management.* Configuration management helps ensure the integrity of hardware and software configurations. It entails developing security-oriented baseline configurations for applications, systems, and devices. The baseline is created by considering things such as disabling unnecessary services and ports or enabling firewalls, antivirus software, and security/audit logging. Configuration management also entails tracking baselines, versions, and other critical information in a central repository. Changes to hardware and software should be managed and controlled to ensure the confidentiality, integrity, and availability of hardware and applications. Effective configuration and change management policies can mitigate risks arising from changes made to networks, platforms, and applications. This can include upgrading network components, patching applications, and remediating system flaws identified after the system was implemented.
4. *Segregation of Duties.* A key element of internal controls is SoD, which entails segregating duties within key processes to prevent individuals from committing and concealing errors or fraud. SoD includes segregating the responsibilities for initiating and approving changes within significant applications. SoD prevents an individual from creating a fictional purchase order and invoice while also approving and processing payment in an accounting application. Work responsibilities should be segregated so an individual does not control all critical stages of a process. From an IT perspective, SoD involves assigning certain responsibilities to different individuals in order to separate incompatible functions, such as application development and computer operations. In addition, user access privileges must be structured to enforce segregation of key duties within information systems. Access privileges must be consistent with the SoD established for manual processes. A user's access should allow for processing capabilities that are consistent with the

employee's role and compatible responsibilities. Periodic reviews of user accounts should be performed to identify and correct any user access privileges that violate SoD controls or principles of least privilege. Principles of least privilege entail assigning individuals the fewest privileges that are consistent with their role(s). If SoD is not feasible in some cases, compensating controls should be employed to prevent errors and fraud.

5. *Contingency Planning.* Contingency planning entails being able to recover from a disruptive event, whether it is a power outage or a natural disaster, and continue operations. It is imperative that organizations employ plans for recovering from a potential disruptive event and continuing operations. Losing the capability to process, retrieve, and protect electronically maintained information can significantly affect an entity's ability to accomplish its mission. If contingency planning controls are inadequate, even relatively minor interruptions can result in lost or incorrectly processed data, which can cause financial losses, expensive recovery efforts, and inaccurate or incomplete information. Given these severe implications, it is critical that an entity have procedures in place for protecting information resources and minimizing the risk of unplanned interruptions as well as a plan to recover critical operations, should interruptions occur. Such plans should consider the activities performed at general support facilities, such as data processing centers and telecommunications facilities, as well as those performed by users of specific applications. To determine whether recovery plans will work as intended, they should be tested periodically in disaster simulation exercises. FISMA requires that each Federal Agency implement an information security program that includes "[p]lans and procedures to ensure continuity of operations for information systems that support the operations and assets of the agency."

### **Business Process Application Controls**

Business processes are the activities of an organization that support its mission and goals. Business processes can entail HR, payroll, and security in addition to the tasks associated with the type of entity the organization is, such as education or manufacturing. Typically, organizations employ applications to support their business processes. Frequently, these applications are processing, migrating, and/or storing sensitive data and information, including employee/customer PII and financial transactions used for the organization's financial statements. Business process application controls are put in place to ensure transactions and data processed by the applications are complete, accurate, valid, confidential, and available. Business process application controls consist of application-level controls, business process controls, interface controls, and data management system controls.

- *Application-level controls.* Application-level controls entail the general control areas of security management, access controls, configuration management, SoD, and



contingency planning but at the business process application level. Just as general controls operating at the entity-wide and system level must be tested, business process applications must be tested as well.

- *Business Process Controls.* Business process controls are automated and/or manual controls applied to ensure complete, accurate, valid, and confidential data and transactions processed by business process applications. This encompasses controls over:
  - Data that enters the application (transaction data input).
  - Data integrity (transaction data processing).
  - Transaction data output.
  - Shared data (master data setup and maintenance).
- *Interface Controls.* Inevitably, applications have interfaces that create a need for controls to ensure timely, accurate, and complete processing of information between applications, in addition to preserving the confidentiality of the sensitive interface data. Interface controls are employed for seamless data migration between source and destination systems. Interface controls entail:
  - Developing an interface strategy so data between applications is synchronized properly.
  - Ensuring source data from source applications are converted into the format required by target applications.
  - Ensuring data imports do not result in duplicate or lost data between applications by ensuring that only required fields are extracted in data extractions.
  - Identifying and correcting errors in processing between applications.
  - Ensuring access to interface data and processes is restricted.
- *Data Management System Controls.* Often, applications leverage a data management system, such as a database, data warehouse, and/or middleware, for entering, storing, retrieving, or processing data. This necessitates data management system controls, such as authentication/authorization/privilege controls for accessing the data and SoD controls for separation of responsibilities between the applications and data management systems.

*FISCAM* can also be used in financial statement audits in which assessments of information system controls are completed to evaluate the controls over financial systems and reporting while also assessing the reliability of financial data. The nature and extent of information system controls audit objectives and procedures will vary depending on whether the audit is performance based or an attestation.

GAO's Yellow Book requires auditors to gain an understanding of the internal controls over financial reporting to determine the risk of material misstatements of the financial statements, whether due to errors or fraud. In addition, the amount of substantive testing is based on the auditor's ability to rely upon internal controls over financial reporting. Once

key controls are identified during the planning and understanding internal controls phases, tests of control design and operating effectiveness are performed. If the internal controls over the financial system containing the financial data are operating effectively and a certain level of comfort is obtained, the audit team may decide to decrease the testing of manual controls and/or the extent of substantive transaction testing.

In addition to prescribing standards for financial statement audits, the Yellow Book provides standards covering attestation engagements (i.e., SSAE 16) and performance audits. As opposed to financial statement audits whose objective is to opine on the presentation of financial statements, performance audits may have very narrow or broad objectives and often address subjects that are not financial oriented, such as information security and privacy. In practice, most agency IGs conduct annual FISMA evaluations using GAO's Performance Audit criteria in Chapters 6 and 7 from the Yellow Book, 2011 Revision.

### **Statement on Standards for Attestation Engagements (SSAE) No. 16**

SSAE 16 is a new standard for service organizations or service providers and replaces AICPA's Statement of Auditing Standards No. 70 (SAS 70), *Service Organizations*. SSAE 16 sets standards for performing and reporting on internal controls at a service provider by an independent certified public accounting (CPA) firm. Within the Federal Government, there is an increasing trend for Federal Agencies to leverage the capabilities of a government-sponsored shared service provider to reduce overlap within the Federal Government and promote greater efficiencies.

Several of the larger Federal service providers for accounting, payroll, and budget support include USDA's National Finance Center (NFC), Department of Interior's National Business Center (NBC), DoD's Defense Financial and Accounting Service (DFAS), and U.S. Treasury's Bureau of Public Debt's Accounting Resource Center (ARC). These Federal service providers and other agencies regularly contract for external CPA firms to perform SSAE 16 attestation engagements over their information systems and internal controls supporting their Federal customers. To promote efficiency and avoid each Federal customer contracting for IT audit services independently, these service providers contract with a CPA firm to evaluate the design and operating effectiveness of internal controls over financial reporting. Typically, these Federal service providers select controls from each of *FISCAM*'s general and application control areas and request that the CPA firm attest to the design and operating effectiveness for these selected controls. If the delivered IT services to other Federal Agencies involve processing PII (such as processing grants or applications for benefits from U.S. citizens), the scope of the SSAE 16 will likely include privacy controls and associated test procedures from the Privacy Act and Section 208 of the E-Government Act.

The most common and preferred SSAE 16 report is a "Type II" report. In a Type II report, the service auditor will express an opinion and report on the subject matter provided by the management of the service organization as to (1) whether the service

organization's description of its system fairly presents the service organization's system that was designed and implemented throughout the specified period; (2) whether the controls related to the control objectives stated in management's description of the service organization's system were suitably designed throughout the specified period to achieve those control objectives; and (3) whether the controls related to the control objectives stated in management's description of the service organization's system operated effectively throughout the specified period to achieve those control objectives. When external auditors receive a "Type I" report from a service organization, they should exercise greater caution and professional skepticism. A Type I is less thorough than a Type II and does not include an opinion on controls' operating effectiveness. The scope of a Type I report only states whether the controls related to the control objectives stated in management's description of the service organization's system **were suitably designed** to achieve those control objectives—also as of a specified date.

The successful delivery of SSAE 16 services in the Federal marketplace requires an IT auditor to be knowledgeable and experienced in Federal IT security and privacy laws, regulations, OMB requirements, and NIST guidance.

## **GROWING DEMAND FOR IT AUDIT AND INFORMATION ASSURANCE SERVICES**

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Federal Agencies are continuously under attack from criminals and foreign entities trying to compromise the confidentiality, integrity, and availability of Federal information and information systems. Therefore, the government has stepped up efforts to mitigate information security risks and provide an efficient means for managing information security and reporting on compliance.

As government requirements for evaluating and securing Federal information systems are evolving, there has been an increasing demand for IT audit and assurance services to analyze information system controls at Federal Agencies or Federal contractor sites and mitigate identified risks. FISMA and OMB require government service providers handling Federal information or managing systems on behalf of the Federal Government to comply with Federal security standards. Therefore, Federal Government service providers are tailoring their services and systems to meet Federal security standards. Doing this entails security assessments, authorizations, and continuous monitoring of IT services provided to Federal Agencies by cloud computing organizations and SSAE 16 assessments of systems containing Federal information. The next discussions cover the five highest-growth areas within the Federal IT audit and information assurance space.

1. *Federal cloud computing requirements.* Cloud computing is defined by NIST as "a model for enabling convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications,

and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.” According to NIST, “*Cloud computing* allows computer users to conveniently rent access to fully featured applications, to software development and deployment environments, and to computing infrastructure assets such as network-accessible data storage and processing.”

Cloud computing entails employing an external service provider to manage application services of the organization. These services include software as a service (SaaS), platform as a service (PaaS), and infrastructure as a service (IaaS). Cloud service providers typically deliver these services through the Internet, although some may use private telecommunication circuits in IaaS and PaaS arrangements.

IaaS entails renting hardware (servers, storage, network devices, and virtualization) from a cloud service provider to support operations and access through the Internet. The organization still manages its own applications, data, and operating system(s). In lieu of the organization maintaining an on-site data center, the organization is paying a cloud service provider to utilize their data centers.

PaaS allows an organization a platform (network, servers, storage, etc.) to test, build, and host custom applications. The organization manages its own applications and data while the service provider manages the operating system, hardware, networking, and server virtualization.

SaaS allows users to access applications and programs hosted by a cloud service provider through its Web browser. Everything required to manage the applications is handled by the cloud service provider. Organizations benefit in many ways: (1) They save money by not purchasing expensive application servers and associated software to host the applications. (2) They spend less on end user machines as less computing power and associated client licenses are required to run business applications. (3) Organizations avoid staffing IT operations on a 24 × 7 × 365 basis.

Building on a commercial trend to utilize commercial cloud providers, the government initiated efforts to expand the use of commercial cloud providers. In December 2010, OMB announced a policy requiring Federal Agencies to consider the use of cloud services. The “Cloud First Policy” entails migrating technology services to the cloud if secure, cost-efficient, and reliable cloud-based solutions existed. Parallel to the Cloud First Policy is a broader goal to reduce the number of government data centers.

In May 2011, NIST released SP 800-146, *Cloud Computing Synopsis and Recommendations*, which provides a risk analysis for cloud computing in addition to providing insight as to how and when to use cloud computing services.

2. *FedRAMP and Cloud Service Assurance*. To expedite compliance with OMB’s Cloud First Policy, the General Services Administration (GSA) established the Federal Risk and Authorization Management Program (FedRAMP) to provide Federal Agencies with a repository of assessed and authorized cloud services.

FedRAMP also outlines a process for security assessments, authorization, and continuous monitoring of cloud computing products and services not currently included in the FedRAMP repository. Cloud service providers (CSPs) expecting to service Federal Agencies must use an accredited third-party assessment organization (3PAO) to ensure their cloud service(s) comply with FedRamp requirements. One of FedRAMP's goals is to boost agency confidence in the security of cloud services.

3. *SSAE 16*. As previously mentioned, SSAE 16 attestation examinations provide agencies assurance that systems managed by an external service provider containing agency financial data can be relied upon for financial reporting purposes. With the continuing trend to outsource IT services, government service providers, such as USDA's NFR, Interior's NBC, DoD's DFAS, and Treasury's ARC, seek SSAE 16 attestation reports over their systems as evidence that sufficient internal controls exist over financial reporting.
4. *Continued expansion of COTS*. To reduce software development and customization costs while obtaining demonstrated performance, government agencies have migrated from building custom applications to purchasing government off-the-shelf (GOTS) and COTS products. GOTS products are deployed specifically for government use and are typically developed by an external entity contracted by the government. COTS products are sold in the commercial marketplace and not developed primarily for government usage; however, the government may leverage certain COTS products that meet agency objectives.

Trusted Agent FISMA (TAF), Automated System Security Evaluation and Remediation Tracking System (ASSERT), and Cyber Security Assessment and Management (CSAM) are some Web-based GOTS tools utilized by Federal Agencies in centralizing security-related information to manage FISMA compliance. Some COTS products commonly used by the Federal Government include PeopleSoft Human Resources, PeopleSoft Financials, Oracle e-Business Suite, CGI's Momentum Financials, SAP, and countless other software products from IBM, Hewlett-Packard, and Microsoft.

With any new development, there usually is a period of time during which applications undergo a number of patches and updates before they operate as intended and are secure. The trend to utilizing GOTS and COTS products has lessened the need for the government to fund the development of redundant information systems offering similar functionality. The competitive marketplace to win government business has generally improved the overall quality and broadened the functionality offered to the Federal Government.

The trend to utilize outsourced information systems will continue and will drive market demand for IT audit and information services. Any system, whether it is GOTS or COTS, must undergo security assessment, authorization, and

- continuous monitoring to ensure it complies with Federal security requirements in mitigating security risks and the potential compromise of the confidentiality, integrity, or availability of Federal information.
5. *Government outsourcing.* There has been a continuing trend for government to outsource IT operations to third-party organizations. This trend allows Federal Agencies to focus on operations supporting agency missions, save money, and reduce redundancy of building similar systems.

## CLOSING THOUGHTS

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The Federal Government recognizes the significance of cybersecurity as evidenced by the laws, regulations, standards, and guidance it has put in place to promote information security and privacy. In addition, the government has spent billions of dollars annually on information security and protecting Federal computer networks. Even so, the number of cyberattacks increases annually. The government realizes it will continue to be the target of criminals and is continually enforcing current requirements while developing new requirements as technology progresses and new risks are identified. Cybersecurity will continue to grow as new cyberthreats emerge; therefore, the need for IT auditors to analyze and ensure that Federal Agencies and their contractors are meeting information security requirements will increase.

# 14 PERFORMANCE AUDITS

## ***Different Scopes, Different Folks, Different Reports***

### **PERFORMANCE AUDITING: MINIMAL GUIDANCE, NO SAFE HARBORS**

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#### **Performance Audits: Origin and Credits**

Performance audits generally assess the efficiency and effectiveness of operations and programs. The objectives, purposes, and scope of such audits vary with the parties desiring a performance audit. Financial audits have the support of over 100 years of uniformity, documented precedent, precise guidance, and general acceptance. Performance audits, however, lack uniformity, have little precedent, minimal guidance, and, at times, lack auditee acceptance. Nonetheless, performance audits are valuable and are often demanded to answer important questions left unanswered by annual financial statement audits, particularly in the public sector.

While many assume that accountants “invented” performance auditing, this method of evaluation and analysis is practiced possibly to a greater degree in the social sciences and other disciplines. For years, nonaccountants have conducted scores of successful performance audits that blend the scientific research method (who, what, when, where, why, and how) with rigorous social research techniques and rather different data-gathering and documentation practices. Such approaches merge cross-disciplinary skills and practices, placing greater emphasis on current or contemplated activity and performance, in contrast to the historical emphasis of an accountant’s audit of financial statements.<sup>1</sup>

Observers not known for their public sector involvement have, without qualification, concluded that service institutions, such as governments, periodically need an organized audit of objectives and results in order to identify those entities no longer serving a purpose or that have proven the desired objectives are not attainable.<sup>2</sup>

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<sup>1</sup> Frank L. Greathouse and Mark Funkhouser, “Audit Standards and Performance Auditing in State Government,” *Government Accountants Journal* (Winter 1987–1988): 56–60.

<sup>2</sup> Peter F. Drucker, *Management: Tasks, Responsibilities, Practices* (New York: Harper & Row, 1973), Chapter 14.

### Performance Audits: Elusive Scopes, Changing Views over Years

For at least 100 years, formal recognition has concluded that audits of financial statements validating historical data have left unanswered questions about quality of operations, competitive status, competence of management and staff, and overall effectiveness of operations. Robert Montgomery, a leader in financial auditing (and founding partner of an original Big 8 accounting firm, Lybrand, Ross Brothers & Montgomery), called attention to the need for audits with considerably different scopes than standard financial statement audits of the early 1900s. He noted that other investigations or examinations were necessary to obtain information about the affairs of and to learn the truth about alleged fraudulent transactions, infringements, rights, arbitration, or values.<sup>3</sup> In the 1980s, some attempted to distinguish between shades of performance-type audits. One separately defined management audits, operational audits, and performance audits in this manner:

- *Management audits.* Reviews and evaluations of management's performance, taking into account environmental conditions, decisions made, results obtained, and similar factors.
- *Operational audits.* The analysis and evaluation of an organization and its operations, often including reviews of structure, systems design, procedures, controls, and results. Similar to a management audit, but with more emphasis on the organization than on management.
- *Performance audits.* Reviews of a governmental program to determine whether it is effectively meeting its objectives, considering the promised benefits in relation to actual results and costs.

In the 2000s, members of academe offered slightly different views of performance auditing. *Operational auditing* was defined as a subset of internal auditing (the other subsets being financial auditing, compliance auditing, and fraud auditing). Further, *management auditing* was cataloged as a subset of operational auditing, which attempted to measure the effectiveness and efficiency of an entity.<sup>4</sup>

Another contemporary view is that an *operational audit* is one that emphasizes effectiveness and efficiency and is concerned with operating performance oriented toward the future; financial audits, in contrast, are oriented to the past, with the emphasis on historical information. While operational audits are generally understood to deal with effectiveness and efficiency, there is less agreement with the use of the term than one might expect. Many prefer to use terms such as *management auditing* and *performance auditing*,

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<sup>3</sup> Robert Montgomery, *Auditing Theory and Practice* (New York: Ronald Press Company, 1934), p. 647.

<sup>4</sup> Larry F. Konrath, *Auditing: A Risk Analysis Approach*, 5th ed. (Independence, KY: Southwestern, 2001), p. 669.



while others do not distinguish between *operational auditing*, *management auditing*, and *performance auditing*.<sup>5</sup>

Of more relevance to managing and overseeing the activities of public bodies, especially those of the Federal Government, is the recent definition of performance auditing by the Government Accountability Office (GAO), appearing in the 2011 edition of its *Government Auditing Standards* (Yellow Book):

Performance audits provide findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.<sup>6</sup>

Because each performance audit has unique objectives, the scopes of such audits must be tailored to achieve those specific desires. Thus, these audits must be conducted in conformance with criteria other than those employed for financial audits. This flexibility makes performance audits powerful accountability and evaluation tools since audits can be structured in many different ways, depending on the need. For the most part, performance audits are the province of GAO, Federal Inspectors General, state and local auditors general, and governmental internal auditors. At times, however, independent accounting firms are retained under contract by a governmental entity to conduct performance audits.

### **Performance Audit Standards: General, Fieldwork, Reporting Standards**

More than any organization, GAO should be credited with broadening the focus of audits applied to governments, particularly the Federal Government. The need for an expanded audit focus was formalized in 1972, after extensive research, by GAO in its Yellow Book. The foreword of the 1981 edition of the Yellow Book noted:

Public officials, legislators, and private citizens want and need to know, not only whether Government funds are handled properly and in compliance with laws and regulations, but also whether Government organizations are achieving the purposes for which programs are authorized and funded, and are doing so economically and efficiently.

The foreword to the 2011 Yellow Book stated that the Federal Government's audit standards "provide a framework for performing high-quality audit work with competence,

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<sup>5</sup> Alvin Arens and James Loebbecke, *Auditing: An Integrated Approach*, 8th ed. (Upper Saddle River, NJ: Prentice Hall, 2000), p. 797.

<sup>6</sup> Government Accountability Office, *Government Auditing Standards*, 2011.

integrity, objectivity, and independence to provide accountability to help improve Government operations and services.”

To this day, the Yellow Book provides the most definitive standards for the conduct of performance audits. These auditing standards appear in the 2011 edition:

- Chapter 3, “General Standards,” to be applied to the conduct of financial audits, as well as performance-type audits
- Chapter 6, “Field Work Standards for Performance Audits,” covering planning, supervising, gathering evidence, and preparing audit documentation for performance audits
- Chapter 7, “Reporting Standards for Performance Audits,” covering performance audit report format, content, quality, and distribution

The unique nature of performance audits dictates that each must be planned individually. By definition, each performance audit has different objectives, warranting different scopes of inquiry, requiring different audit skills, and resulting in a specially formatted report that is responsive to the specific audit objectives of only that performance audit.

### **GENERAL STANDARDS: INDEPENDENCE, PROFESSIONAL JUDGMENT, COLLECTIVE COMPETENCE, QUALITY CONTROL AND ASSURANCE**

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Adherence to *Government Auditing Standards* is essential to ensure the credibility of individual auditors, the competence of the audit team, and the professionalism of their audit organization. Compliance with the general audit standards described in the Yellow Book is critical to the success of any audit. These general standards speak to topics such as these:

- Auditor independence
- Exercise of experienced professional judgment
- Collective high competence of the audit team
- Organizational quality controls of audit organizations to ensure adherence standards

The general standards applicable to performance auditing are described next.

#### **Independence**

The first general standard *Government Auditing Standards* (GAS 3.02–3.59) pertains to independence:

In all matters relating to the audit work, the audit organization and the individual auditor, whether Government or public, must be independent.

This standard on independence is more specific than the comparable American Institute of Certified Public Accountants (AICPA) standard. However, Statements on

Auditing Standards (SAS), and additional AICPA guidance issued over the years require that members conform to essentially these same requirements. The 2011 GAO Yellow Book update also provides an extensive framework for assessing independence. Where a nongovernment auditor suffers from one or more of the cited independence impairments—personal, financial, external, or organizational—that auditor must decline to perform the work.

An auditor who is an employee of a government may not, due to legislative or other requirements, be able to decline to perform the audit. In this instance, the government employee must report the impairment(s) in the scope section of the audit report.

### **Professional Judgment**

The second general standard (GAS 3.60–3.68) concerns professional judgment:

Professional judgment should be used in planning and performing audits and in reporting the results.

GAO requires the exercise of reasonable care and diligence, the highest degree of integrity, and objectivity in applying professional judgment. This standard imposes a responsibility on performance auditors to observe *Government Auditing Standards* and to describe, justify, and disclose any departures from these standards.

### **Collective Competence of Audit Team**

The third general standard (GAS 3.69–3.81) pertains to the collective competence of the audit team:

The staff assigned to perform the audit or attestation engagement should collectively possess adequate professional competence needed to address the audit objectives and perform the work in accordance with generally accepted government auditing standards (GAGAS).

By this standard, the audit organization is responsible for ensuring that, collectively, the audit team has the knowledge, skills, and experience necessary to successfully complete the performance audit. Compliance with this standard requires audit organizations to have a process for recruiting, hiring, continuous development, and evaluation of staff to ensure a continuing workforce with adequate professional competence. For performance auditing, *professional competence* refers to the knowledge, skills, and experience of the assigned audit team, and not necessarily an individual auditor.

To conduct a performance audit, an audit organization may need to employ specialists, other than auditors, who are knowledgeable, skilled, or experienced in such areas as accounting, statistics, law, engineering, health and the medicines, information technology (IT), public administration, economics, social sciences, or actuarial science. Since performance audits often involve assessing program effectiveness, it is particularly important that

the audit team include program experts. This standard ensures that auditors and their organizations are aware that training and proficiency as an auditor only will not be adequate for performance audits requiring knowledge and skills in other fields.

GAO's interpretative guidance requires an audit staff to collectively possess the necessary technical knowledge, skills, and experience and be competent for the type of work being performed *before* beginning the audit.

### **Quality Control and Assurance**

The fourth general standard (GAS 3.82–3.107) pertains to quality control and assurance:

Each audit organization performing audits and/or attestation engagements in accordance with GAGAS must 1) establish and maintain a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and 2) have an external peer review performed by reviewers independent of the audit organization being reviewed at least once every three years.

An appropriate internal quality control system encompasses the structure, operating policies, and procedures for monitoring, on an ongoing basis, whether the policies and procedures of an audit organization are suitably designed and are being effectively applied during each audit. The internal quality control system must be documented to permit evaluation and review to assess compliance.

To conform to this standard, audit organizations, both government and nongovernment, must have an external peer review of their auditing and attestation practice at least once every three years by reviewers independent of the audit organization.

## **FIELDWORK STANDARDS: PLANNING, SUPERVISION, SUFFICIENT AND COMPETENT EVIDENCE, DOCUMENTATION**

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Fieldwork audit standards provide guidance for the conduct of a performance audit in conformity with *Government Auditing Standards* and are discussed next.

### **Planning Performance Audits**

The first fieldwork performance audit standard (GAS 6.0–6.12) pertains to planning performance audits:

Auditors must adequately plan and document the planning of the work necessary to address the audit objectives.

The plan for a performance audit should define, to the best detail possible, the audit objectives, scope, program performance criteria, and anticipated methodologies

to be employed. Planning for a performance audit, even moreso than for a financial audit, is an iterative process that will continue to evolve over the duration of the audit. Planning for a performance audit is not a once-and-done task. The audit plan should be reduced to writing, becoming a part of the working papers and the audit evidence record.

### **Supervision of Performance Audits**

The second fieldwork performance audit standard (GAS 6.53–6.55) pertains to supervision of performance audits:

Audit supervisors or those designated to supervise auditors must properly supervise audit staff.

The level and extent of supervision expected will vary in relation to the experience of individual team members. Those with less experience or who are new to the audit team would require more frequent monitoring. Evidence of supervision and review of teamwork should be documented in audit work papers.

### **Obtaining Sufficient, Appropriate Evidence**

The third fieldwork performance audit standard (GAS 6.56–6.59) concerns obtaining sufficient, appropriate evidence:

Auditors must obtain sufficient, appropriate evidence to provide a reasonable basis for their findings and conclusions.

The quality, quantity, type, reliability, and validity of evidence are all relevant to the objectives of the specific performance audit and dependent on the judgment of the auditor. Categories of evidence suggested by GAO and considered in most performance audits include:

- *Physical evidence.* Direct auditor inspection and observation of people, property, and events, documented in memoranda, photographs, charts, maps, or physical sample
- *Documentary evidence.* Letters, contracts, accounting records, invoices, and management information on performance
- *Testimonial evidence.* Inquiries, interviews, questionnaires, and written representations
- *Analytical evidence.* Computations, comparisons, data disaggregation by components, and rational argument

Evidence must be competent (i.e., valid, reliable, and consistent) with the facts reported by the audit team, which requires that the evidence be accurate, authoritative, timely, and authentic.

### **Performance Audit Documentation**

The fourth fieldwork performance audit standard (GAS 6.79–6.85) pertains to performance audit documentation:

Auditors must prepare audit documentation related to planning, conducting, and reporting for each audit. Auditors should prepare audit documentation in sufficient detail to enable an experienced auditor, having no previous connection to the audit, to understand from the audit documentation the nature, timing, extent, and results of audit procedures performed, the audit evidence obtained and its source and the conclusions reached, including evidence that supports the auditor's significant judgments and conclusions.

The form, content, quantity, and type of documentation constitute the principal record of the work performed for the audit; aid auditors in conducting and supervising the audit; and allow for a review of audit quality. Evidence of supervisory review must exist in the audit's work papers before the audit report is issued.

### **REPORTING STANDARDS: WRITTEN REPORTS, REPORT CONTENT, QUALITY REPORTING, REPORT DISTRIBUTION**

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The reporting standards for a performance audit provide guidance to the auditor on reporting on performance in accordance with *Government Auditing Standards*. These reporting standards are discussed next.

#### **Written Audit Reports**

The first reporting standard for performance (GAS 7.03–7.07) pertains to written audit reports:

Auditors must issue audit reports communicating the results of each completed performance audit.

A performance audit report must be written and appropriate for the report's intended use.

#### **Content of Audit Reports**

The second reporting standard for performance (GAS 7.08–7.43) pertains to the content of audit reports:

Auditors should prepare audit reports that contain 1) the objectives, scope, and methodology of the audit; 2) the audit results, including findings, conclusions, and recommendations, as appropriate; 3) a statement about the auditors' compliance with GAGAS; 4) a summary of the views of responsible officials; and 5) if applicable, the nature of any confidential or sensitive information omitted.

The auditor should ask legal counsel if publicly reporting certain information about potential fraud, illegal acts, violations of provisions or grant agreements, or abuse would compromise investigative or legal proceedings. Auditors should limit the extent of any public reporting to matters that would not compromise such proceedings, such as to information that is already part of the public record.

### **Distributing Audit Reports**

The third reporting standard for performance (GAS 7.44) concerns distributing audit reports:

Audit organizations in Government entities should distribute audit reports to those charged with governance, to the appropriate audited entity officials, and the appropriate oversight bodies or organizations requiring or arranging for the audits. The head of internal audit organization should communicate results to parties who can ensure that the results are given due consideration (in accordance with GAS and Institute of Internal Auditors' Internal Standards for the Professional Practice of Internal Auditing). Public accounting firms contracted to perform an audit in accordance with GAGAS should clarify report distribution responsibilities with the engaging organization.

Internal auditors employed by governments should follow their audit entity's own arrangements and statutory requirements for distribution.

## **STRUCTURING A PERFORMANCE AUDIT: INTERESTING, CHALLENGING, AND NOT WITHOUT RISK**

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### **Three "E" Audits: Audits for Economy, Efficiency, Effectiveness**

In the Federal Government, GAO describes program (or performance) audits in two general categories:

1. Audits and evaluations made to assess the relative economy and efficiency of an entity's operations. Suggested objectives by GAO of this type of performance audit include whether:
  - The appropriate type, quality, and amount of resources are procured at appropriate prices.
  - An entity's assets are being properly protected, maintained, and used.
  - Optimum amounts of entity resources are used in producing or delivering the legislated or funded services and goods.
  - An entity is complying with the laws, policies, regulations, rules, procedures that affect the acquisition, protection, and use of government resources.
  - An entity has adequate control systems for measuring, monitoring, and reporting on the relative economy and efficiency of operations.

2. Audits and evaluations made to assess program results and the relative operational effectiveness, accomplishments, attained performance, goals achieved, legislated or mandated service outcomes delivered. Suggested objectives by GAO of this type of performance audit include whether:
  - The goals or objectives of a new or ongoing program are proper, suitable, or relevant.
  - The entity is achieving the desired level of performance or program results.
  - Alternatives are considered for delivering program services or goods that would be more effective (i.e., is there a better way?).
  - Established program/performance indicators are valid and reliable criteria of program results.
  - The program focus is on achievement of outputs and outcomes or is limited to the measurement and reporting of inputs only.

This distinction of types of performance audits is clearer in the literature than in practice, wherein the relative economy, efficiency, and effectiveness are relative, interconnected, and at times not clearly distinguishable.

### **Performance Audits: Different and, at Times, Elusive Criteria**

The uniform audit criteria and audit risks for financial statement audits are related to dollar significance or materiality. The criteria for performance audits is not nearly as simple. At times, those arranging for a performance audit are reluctant to, cannot, or will not define or formalize measurable criteria usable in planning a performance audit, yet a performance audit is demanded. The risk of defining acceptable performance often devolves to the audit organization.

Over the years, the AICPA and GAO, in their literature relating to performance auditing, have highlighted risks and other conditions that must be addressed in planning these types of audits. Some of these are listed next.

- *Different materiality, program significance.* A performance audit may not be directly related to dollars but rather gives greater emphasis to qualitative and other quantitative factors and places considerable weight on (a) reports in the written and electronic news media; (b) newness or changes in programs and citizen satisfaction with amounts or types of provided (or not provided) services; or (c) violations or deviations from legislated program goals and objectives.
- *No legislated performance criteria.* Some laws governing programs contain statements of objectives, goals, or desired levels of performance, including defining expected program outputs and outcomes. This information would be ideal for planning a performance audit. Absent such guidance, the auditor must conduct a survey and independently acquire a sufficient understanding of the program to design responsive, relevant program performance criteria, expected levels of program achievement, and/or desired output and outcome measures.



At the outset of the review, the auditor must obtain concurrence of the arrangers of a performance audit to the performance measure to be examined during the audit.

- *Minimal, no relevant program information.* Financial and operational data may not have been captured, recorded, and reported in a manner permitting program managers to effectively manage or monitor performance in strict compliance with the governing laws. Not uncommonly, performance audits require the auditor to design and build ad hoc project databases responsive to the purposes(s) of the audit.
- *Absence of consumer/customer tests.* Restrictions on what evidence an auditor should examine or to whom the auditor may speak will preclude an objective and more meaningful assessment of an auditee's performance. Limiting communication to auditee management and staff and to records and reports compiled by the auditee may provide minimal or no information as to the relevant efficiency and effectiveness of a governmental program. Consumer, customer, or constituent satisfaction could be lacking concerning the types, timing, levels, delivery modes, and so on, of program services and goods. Independently compiled external data relative to program performance, achievement, and quality may be available only if the auditor conducts mailed polls or personal interviews with a substantial sampling of the constituents targeted by the founding law, including constituents served, those underserved, and those not served at all.
- *Outputs, outcomes not identified.* Considerable emphasis may be placed on "input" data (e.g., expenses incurred for salaries, supplies, travel, and so on, but not related to levels of achievement) that are, at best, indirectly related to performance. It would be better to emphasize data on program "outputs" (e.g., goods and services provided, tons processed, numbers graduated, dollars dispersed). Still better yet would be "outcome" data (e.g., educational levels attained, vocational graduates still working two years after graduation, development of a viable alternative energy source). Defining outcomes can be controversial, heatedly disputed, and often dependent upon conflicting views of affected parties. At the time the legislative branch passed enabling legislation to finance and operate a particular governmental program, even legislators may not have agreed on desired outputs, outcomes, or other achievement criteria for the program. At the outset of the review, the auditor must obtain concurrence of the arrangers of a performance audit.
- *Limited use of best practices and benchmarks.* Seek financial and operational comparisons to similar programs operated by entities external to the auditee. Seek data from external sources on relevant best practices and benchmark-type information on what and how others are performing similar activities. Performance by other governments may not have been considered or attempted, yet information on a better way may be available for the price of a phone call. There will be some Governmental programs that are truly unique, never before attempted by any entity

anywhere. For the most part, however, almost every governmental activity has a counterpart in the corporate, academic, or nonprofit world, and technical and “normative” standards may have been developed by longtime practitioners and industry trade associations with more experience than the government, particularly if the program is a new venture for the government.

- *Need auditors with nonaudit skills.* *Government Auditing Standards* emphasize the importance of collective skills, experience, and professional proficiency of the audit team with the objective of creating a multidisciplinary audit team. Experience in the fields of accounting and auditing may be only two of many skills demanded. The perceived competency of the audit team members is key to successful performance audits (i.e., an audit whose findings are accepted and that results in corrective actions). To the maximum extent, auditee management and staff must view audit team members as their professional and technical peers in every way—education, practical knowledge, applied functional skills, relevant industry experience, and general in-depth expertise.

As is evident, the listed conditions and circumstances require that the auditor gains an understanding of audit expectations from the arranger(s) of the audit before commencing work. Failure to do so would result in the auditor assuming considerable risk. Arranger(s) of performance audits should examine, comment upon, and agree to the evaluation criteria to apply throughout the performance audit. This cautionary measure could potentially preclude the auditee from later protesting that the performance criteria and achievement factors evaluated were made up by the auditor and are neither relevant nor intended by the program’s legislation.

Chapter 6 of *Government Auditing Standards* contains advice and guidance to assist in the development of program performance criteria, a methodology for implying or inferring creditable, appropriate, and relevant performance criteria when possibly none was identified in law. This source should be consulted when drafting the audit program and determining the audit procedures to be applied.

## **OVERVIEW OF PERFORMANCE AUDIT PROCESS: PLAN, DO, REVIEW, REPORT**

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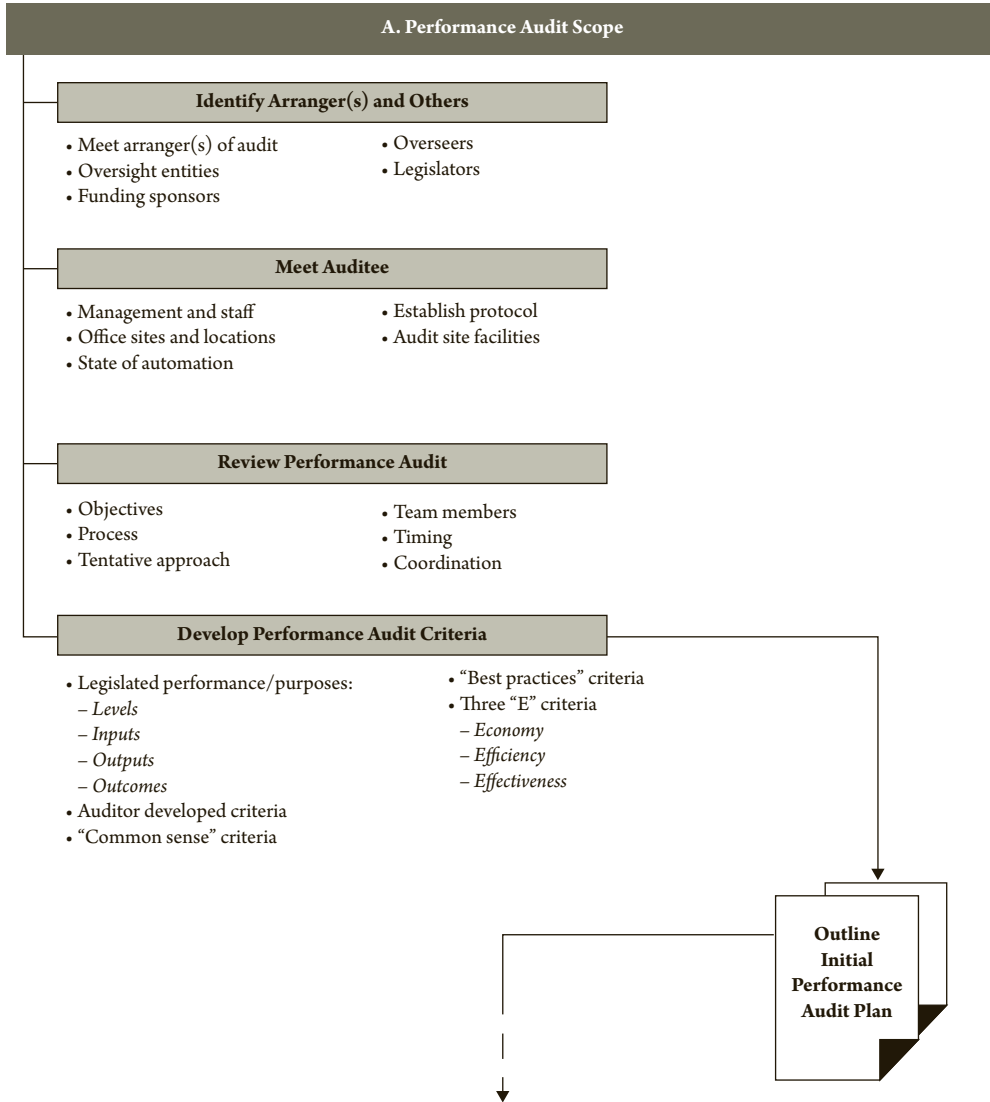
Over 40 years ago, GAO, in its earliest guidance, noted that performance audits may be conducted in uncertain environments, can have different scopes of examination, and may require audit procedures different from those used in the more common financial audits, and that the audit report may require unique tailoring to each specific audit.<sup>7</sup> It is important to keep in mind that because of the flexibility in the way performance audits

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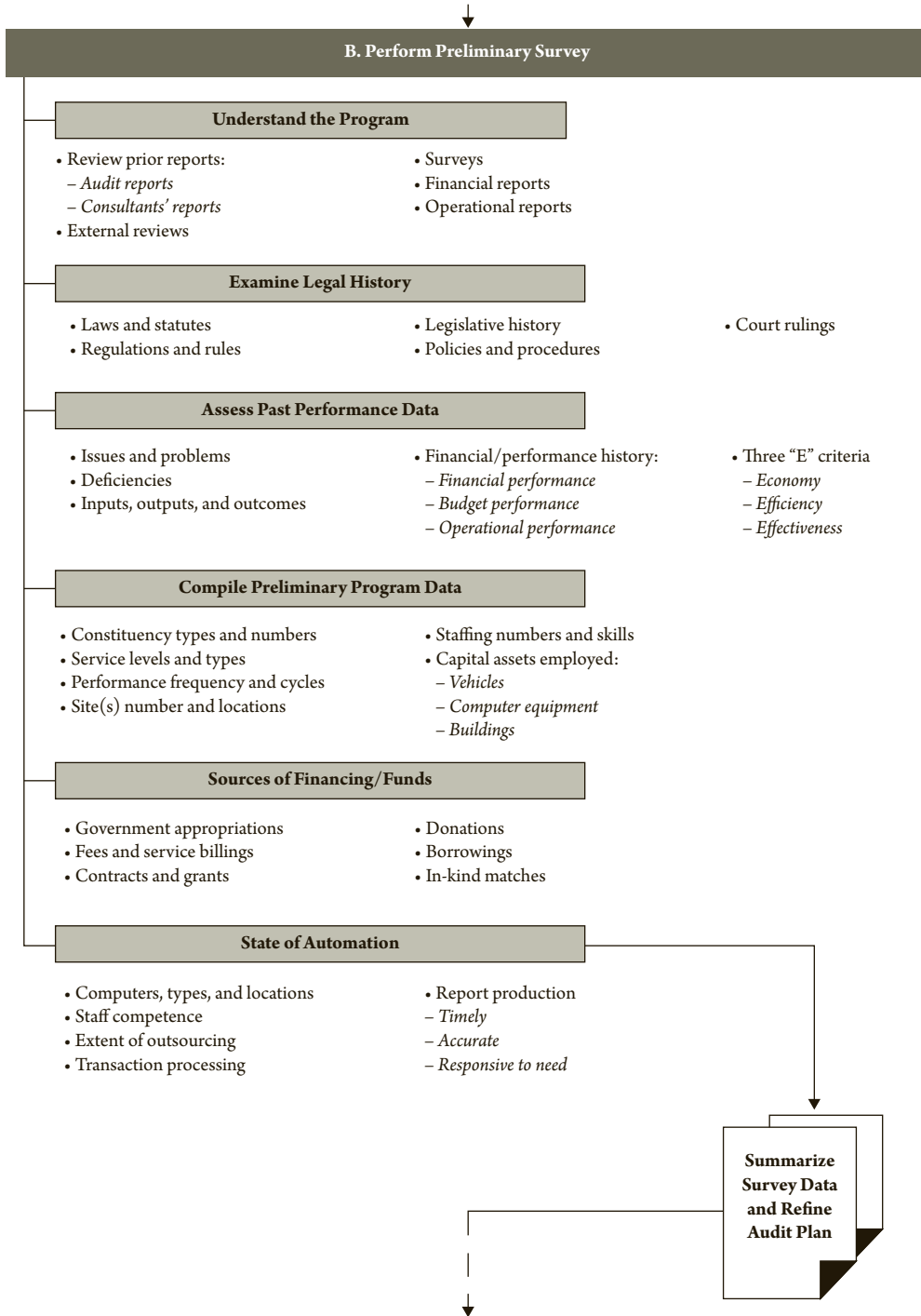
<sup>7</sup> Government Accountability Office, *Comprehensive Approach for Planning and Conducting a Program Results Review*, 1973.

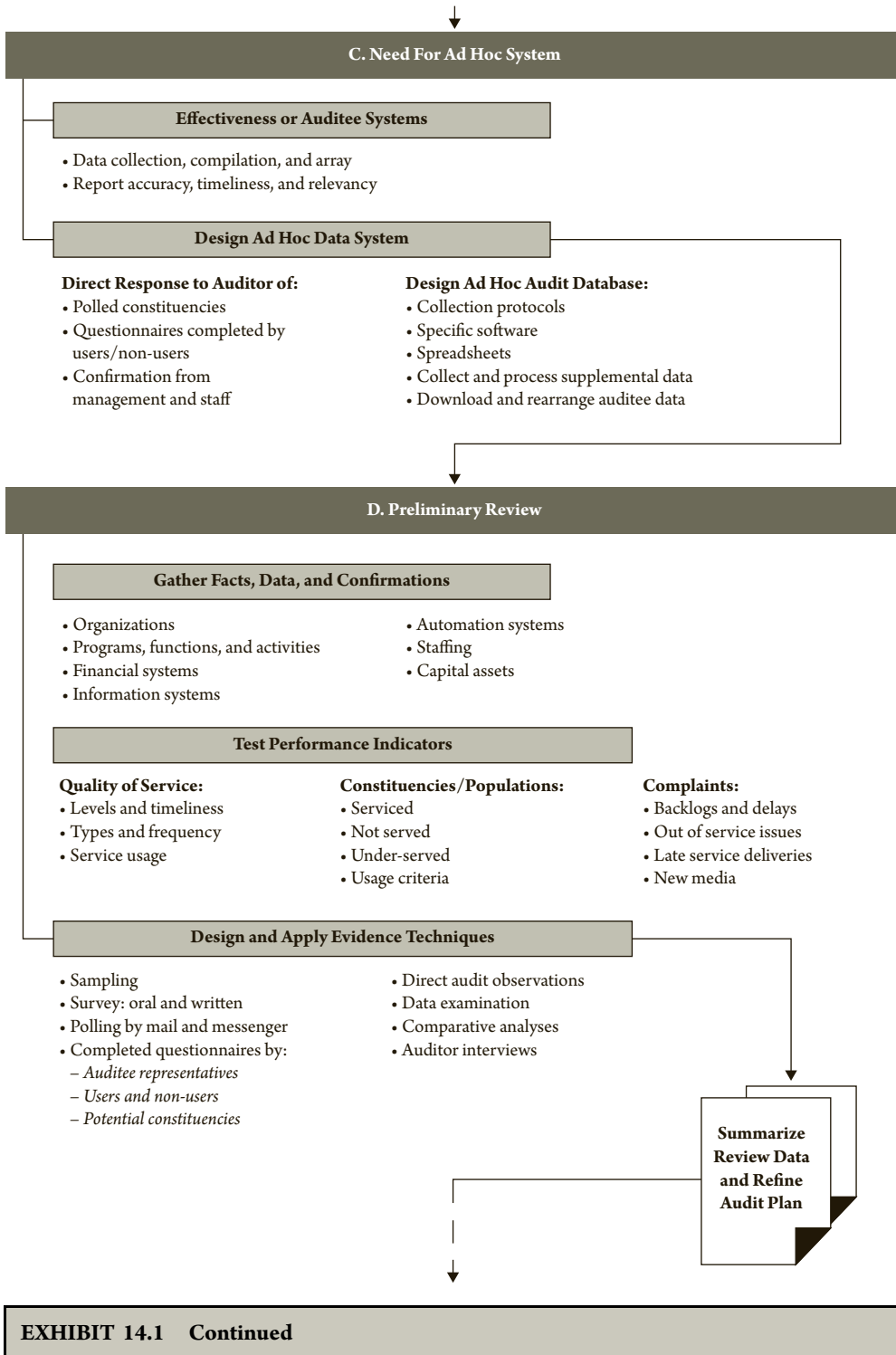
can be planned, they are powerful tools that provide constructive oversight to improve overall management. Nonetheless, GAO outlined a process that could be applied to a performance audit, review, evaluation, or whatever title is used to describe an examination process to assure that the audit is properly planned, professionally performed, and objectively reported.

Exhibit 14.1 is a partial listing of considerations to take into account when planning a performance audit that must conform to criteria of *Government Auditing Standards*.



**EXHIBIT 14.1 Overview of Performance Audit Process**







### E. Conduct Detailed Audit

#### Execute Sample Methodologies

- Document sample execution:
  - Stratification(s)
  - Size(s)
  - Timing
  - Confidences
- Conduct tests
- Sample results
- Analyses
- Projections
- Results/conclusions

#### Questionnaires/Polling

##### Document Execution:

- Nature
- Purpose
- Breadth
- Questions
- Results

#### Sampled Audiences

- Internal
- External
- Users
- Non-users

#### Performance/Quality Inquiry

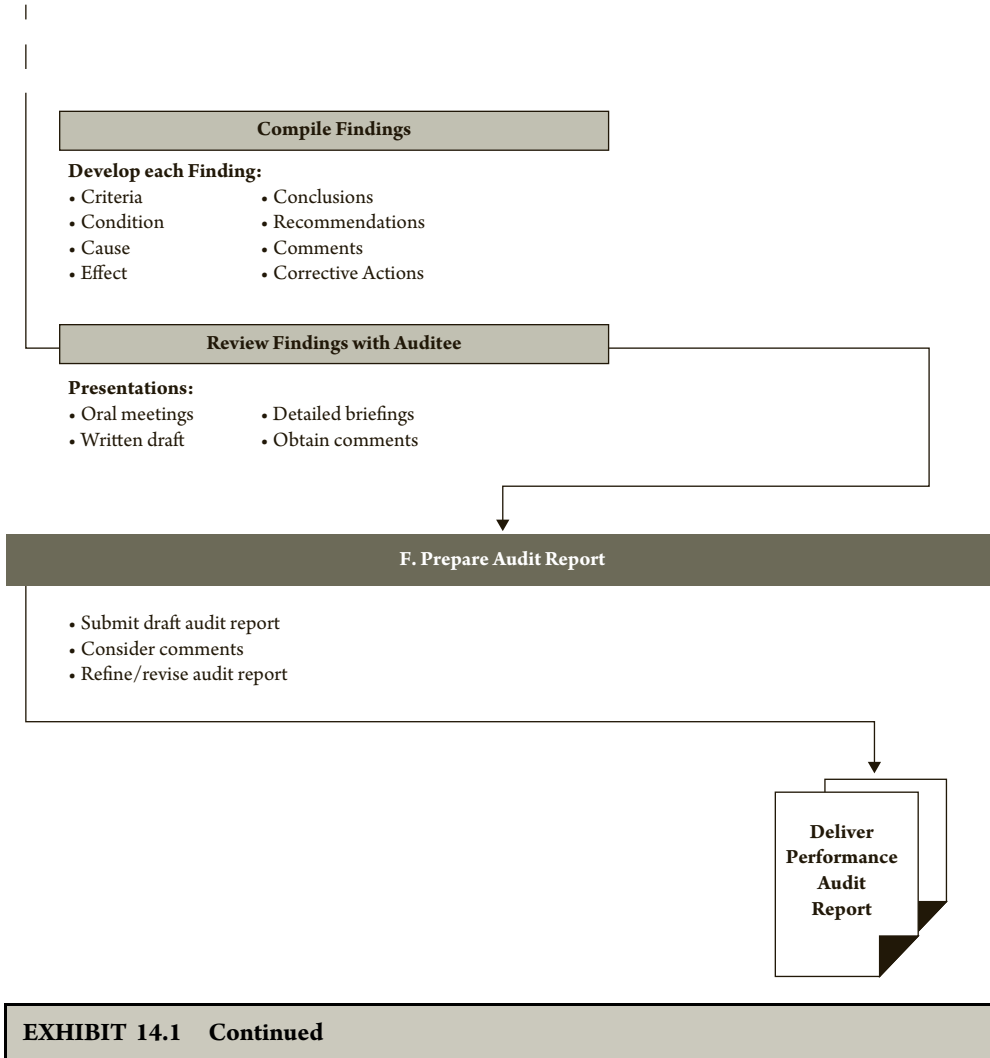
- Timeliness
- Coverage
- Constituencies:
  - Served
  - Under-served
  - Not served
  - Inputs
  - Outputs
  - Outcomes
- Results/conclusions

#### Other Audit Procedures

- Auditor observations
- Site visits
- Personal inquiry
- Document reviews
- Mailed confirmations
- Physical tests
- Results/conclusions

#### Data Analyses

- Pre- and post-audit periods
- Trends
- Variances
- Comparisons
- Ranges
- Limitations
- Budget to actual
- Models
- Best practices
- Results/conclusions



The appropriateness, sequencing, and listed phases and tasks must be assessed in relation to the conditions or circumstances of each auditee and program to be audited. Note that there is a general scope of audit work that must be completed, a methodology that must be applied, and an objective, factually based report that must be submitted to the arrangers of the audit.

The following sections provide an overview of that GAO guidance, some of which exists in GAO’s current edition of *Government Auditing Standards*.

**ORIENTATION PHASE: WITH ARRANGERS OF AUDIT AND AUDITEE**

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Performance audits should not be viewed as necessarily critical or negative. These audits could be beneficially made to identify issues of increased staffing, modernize the equipment plant, or design new management approaches that might be required to significantly expand services and benefits to multiple locations or to several other programs. As early as practicable, the auditor should convene separate orientation conferences with (1) arranger(s) of the audit and (2) auditee management and key staff. The purpose, process, timing, and operating protocols to be applied in the audit must be discussed. The nature of the performance that is to be examined or reviewed should be described to the auditee and alternatives and critical comments seriously examined, before the auditor proceeds to the detailed planning phase.

**Conduct a Survey: Understand the Auditee**

GAO's suggested approach is to conduct a survey at the outset to assess, on a preliminary basis, whether the facts appear consistent with opinions, views, and comments provided earlier by the arranger(s) of the audit and auditee management. The tasks in this phase are directed toward acquiring, as quickly as possible, a historical perspective about the program; its constituents, issues, and accomplishments; extent of computerization; and knowledge of the financial, operational, and other data systems designed to support the program's management and accountability needs.

GAO described the survey as a short-duration, fast information-gathering phase; no real attempt is made to assess or audit the veracity of information provided by the auditee. While problem exploration or deficiency identification may occur, the emphasis is not on doing this. Alternatively, the purpose of the survey is to further enhance background provided to the auditor and assist him or her in understanding the program activities, services, functions, and constituents, each of which will be examined in greater detail as the audit progresses.

**Ad Hoc Database: Often Need One or More**

Depending on the nature of the desired performance audit, data needs could arise relative to these areas and more:

- Quality of services
- Levels of achievement
- Economy and efficiency of program performance
- Input and output and outcome data
- Backlogs and bottlenecks
- Overruns/underruns of financial and performance budgets
- Trend/volume indicators
- Level of user and nonuser satisfaction



The typical historical accounting system will not be fully responsive to the data needs of a performance audit. While a management information system might have some of these data, almost no governmental program's system can address the full range of potential questions that could arise or be of concern.

The creation of an ad hoc database(s) is a precedent condition to planning a performance audit. As early as possible, efforts should be made to identify where there is a shortage of information with respect to the questions and inquiries to be made in the audit. To a greater or lesser extent, an ad hoc database(s) must be implemented, and will include design, drafting, and printing of data collection forms (e.g., form for surveys, polls, auditee-completed questionnaires, mailed confirmations, auditor-prepared inquiry forms, spreadsheets, etc.). In addition, software programs will be needed to input, process, and assist in analyzing collected data. Time devoted at the outset of the audit to brainstorming will be well spent.

#### **REVIEW RISKS AND ISSUES: WINNOWN DOWN AUDIT AREAS**

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GAO contrasts its suggested review phase with the preceding survey phase by the depth and specificity of inquiries. Also, the perceived program issues, problems, deficiencies, and levels of achievement may turn out to be incorrect or not relatively significant, but other more serious matters may arise or be disclosed that require a change of audit focus. Further, no budget would ever permit a comprehensive audit of everything. Choices must be made regarding what is to be examined, and audit focus must change as gathered facts change perceptions. Substantial, high-risk issues may require an audit of considerably greater depth than earlier planned; lesser, lower-risk issues may need to be dropped from further examination.

For these reasons and others, the objective of the preliminary review phase is to permit an informed basis for winnowing down the audit scope and focusing on the most essential, important, critical, or problematic matters and those of highest priority. Early tests must be made of known or derived performance indicators, with recognition that some known indicators may be inadequate and that other, better indicators may be needed. During the review phase, a more complete inventory will be made to confirm the skills and experiences required to competently examine the key issues and complete an assessment of the program. This phase is where more definitive conclusions must be reached concerning the relevancy, currency, accuracy, adequacy, and effectiveness of the auditee's systems controls, accounting, and reporting (e.g., financial, operations, and management information systems). The development of specific audit programs and listing of detailed procedures that must be completed to gather, examine, compile, synthesize, and analyze evidentiary materials should also be completed during this phase. A concluding effort of the review phase must be the refinement or revision of the preliminary audit plan.

## CONDUCT THE AUDIT: GET THE FACTS, FINDINGS

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The detailed audit phase is concerned with obtaining facts to confirm or refute earlier hypotheses, perceptions relative to program achievement, outputs and outcomes, and issues or problems and to gather evidence to permit conclusions on the operational economy, efficiency, effectiveness, and “faithfulness” of program performance and attainment of reported program results.

Getting the facts results from applying a variety of survey and auditing techniques, which GAO suggests could include, among others:

- Statistical applications
- Mathematical modeling
- Auditor interview of management and staff
- Direct mailed questionnaires and confirmations
- Direct polls of constituents, users, and nonusers of the program services
- Physical inspections by the audit team
- Data examination and analyses

The end game of the performance audit is to identify, develop, document, and report audit findings. A *finding* is defined in the Yellow Book as:

The result of information development—a logical pulling together of information to arrive at conclusions about an organization, program, activity, function, condition, or other matter that was analyzed or evaluated.

Care must be taken in any audit to ensure that the audit team does not fall victim to the perfect vision of hindsight. The Yellow Book includes a technique requiring critical examination of the audit evidence gathered in support of what is described by GAO as the several elements of each or any audit finding:

- *Criteria.* What is the required or desired state, or what is expected from the program or operation?
- *Condition.* What did the auditor find regarding the actual situation, providing information on the scope of audit, the extent of the condition, and other comments that would provide an accurate perspective?
- *Cause.* Does the evidence provide a reasonable and convincing argument for the cause as the key factor(s) contributing to the difference between the actual condition and the desired criteria, or does evidence possibly point to flawed criteria or factors not controllable by program management?

- *Effect*. Is there a clear, logical link between what the auditor found (the observed condition) and what should be (the desired criteria) described quantitatively or qualitatively?
- *Conclusions*. Are the auditor's views clearly stated (as opposed to implied); are logical inferences about the program supportable by reported evidence? Are the reported conclusions more than just a summary of the facts?
- *Recommendations*. Does the required recommendation plausibly flow from the reported findings and conclusions and identify actions that could eliminate reported deficiencies or improve programs?

The performance audit report should clearly and objectively report or comment on each of these elements for each reported finding.

### **REPORT OF AUDIT: BRIEFINGS AND INTERIM AND FINAL REPORTS**

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*Government Auditing Standards* do not prescribe a specific form for the audit report but require that the audit report include:

a description of audit objectives and the scope and methodology used for addressing the audit objectives.

As soon as practicable, and if permitted by those arranging for the performance audit, information on these report content items should be provided to the auditee:

- *Objective, scope, and methodology*. This information is needed by readers and users of the report to understand:
  - The purpose of the audit.
  - The nature of the audit work performed.
  - The perspective as to what is reported.
  - Significant limitations in audit objectives, scope, or methodology.
- *Audit results*. The report on audit results should include the creditable evidence in support of each reported finding (i.e., fully report on each element of a finding).
- *Conclusions and recommendations*. Where appropriate or required, this information must flow logically from the facts in the report.

The protocol for presenting audit findings to the auditee will vary and may even be defined by the arranger(s) of the audit. If permitted by the arrangers, the reporting of results of a performance audit might include an overview oral, written, or PowerPoint presentation. A written draft of each finding may be provided to the auditee with a request

for auditee comments, preferably in writing. Following assessment of auditee comments and reconsideration of certain contested issues, a final audit report should be prepared and submitted to the auditee, and the final written views of the auditee will be considered.

Auditors cannot ignore the axiom: Facts not reported cannot be evaluated by readers or users of the audit report. Performance audit reports should provide sufficient information and facts to stand alone, unaided by additional oral or written supplemental testimony or explanations. A performance audit report should be sufficiently complete, in and of itself, to permit a user or reader of the report to audit the auditor.

# 15 PROCUREMENT AUDITS, CONTRACT AUDITS, AND GRANT AUDITS

## CONTRACT AUDITS

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Contract expenditures are some of the most significant expenditures within the Federal Government, with obligations totaling in the trillions of dollars in any given year and individual contracts often reaching into the billions of dollars. Funds are expended under Federal contracts to purchase or support a wide variety of services, purchases of equipment, and real and consumer-type properties. For many agencies, amounts spent under contracts greatly exceed amounts spent on other items in their budgets.

### Contracts Defined

*Contracts* are the legal obligations of the Federal Government, generally in writing, which obligate the government to an expenditure of money upon delivery of goods or performance of services. Federal Government contracting is a preferred form of acquiring services, products, capital assets, real properties, supplies, and materials from non-Federal sources for military and civilian purposes and for use domestically or internationally.

### Contract Types

The types of Federal contracts vary but may be grouped into six general categories, with variations in each grouping:

1. Fixed price
2. Cost reimbursement
3. Incentive
4. Indefinite delivery
5. Time-and-materials, labor-hour, and letter contracts
6. Agreements

*Fixed-price contracts* establish a negotiated price for goods and services when the government can clearly define the outcomes, services, and/or goods. The contractor is responsible for all costs incurred, whether in excess of the negotiated price or not, as long as the scope defined in the contract is consistent with the contract. If the contractor performs the contract for less cost, the contractor remains entitled for the entire contract

amount. These types of contracts provide the government with less risk of cost overruns and costs that are more predictable. Several variations of fixed-price contracts include:

- *Firm fixed-price contracts.* These contracts entitle the contractor to the full amount of the contract at the completion of work defined in the contract scope and acceptance by the government. Typically, contracts define payment schedules for partial payments throughout the period of performance. Absent an authorized change in contract scope, the contractor may collect only the fixed contract price regardless of the cost incurred to perform. The full financial risk is with the contractor.
- *Fixed-price contracts with economic price adjustments.* These contracts provide for upward and downward price adjustments based on established prices, actual costs, or cost indexes established in the contract. These types of contracts exist to compensate for market conditions over extended periods and industry-wide contingencies outside contractor control, such as commodity prices.
- *Fixed-price incentive contracts.* These contracts provide contractors with incentives for adjusting profits based upon an established formula. These contracts establish incentives based upon performance to improve the quality and efficiency of the goods or services provided. The predefined formula established in the contract may increase or decrease the contractor's fees based upon surpassing or missing the performance measures, respectively.
- *Fixed-price contracts with prospective price redetermination.* These contracts provide a fixed price for the initial period of performance or deliveries with a stated redetermination time to adjust the price for services and/or goods that were uncertain at the initiation of the contract.
- *Fixed-ceiling-price contracts with retroactive price redetermination.* These contracts are specific to research and development (R&D) contracts estimated at \$150,000 or less when established and the use of other contract types is impractical. These contracts contain ceiling prices that may be adjusted based upon stated circumstances.
- *Firm-fixed-price, level-of-effort term contracts.* These contracts specify a level of effort at a negotiated fixed price equal to or less than \$150,000.

*Cost-reimbursement contracts* are used when the Federal Agency and contractor are not able to define the required scope of work in sufficiently definite terms, or when there is no valid basis for predicting results or performance. Also, with cost-reimbursement contracts, the financial risks are borne primarily by the governmental entity. Various types of cost-reimbursement contracts are discussed next.

- *Cost contracts.* These contracts reimburse the contractor for allowable costs without any fee or profit. These types of contracts are typically used for R&D-type work through nonprofit entities.
- *Cost-sharing contracts.* These contracts reimburse the contractor for an agreed-to portion of allowable costs; no fee/profit is negotiated into the contract amount

since the contractor anticipates to mutually benefit from performing the scope of work.

- *Cost-plus-incentive-fee contracts.* These contracts reimburse the contractor for allowable costs, plus a variable fee adjusted by a formula based upon a relationship of the total allowable costs to total target costs. These contracts may also include incentives based on technical performance. The intention of these contracts is to provide the contractor with incentives to effectively manage the contract and its related costs.
- *Cost-plus-award-fee contracts.* These contracts reimburse the contractor for allowable costs, plus a negotiated fixed fee as well as an award fee based on meeting contract performance goals. The intention of these contracts is to provide motivation to the contractor to manage costs, schedule, and technical performance.
- *Cost-plus-fixed-fee contracts.* These contracts reimburse the contractor for allowable costs, plus a negotiated fixed fee. The government bears the performance and cost risks because it does not provide incentives to the contractor for effectively managing performance or costs. Use of these contracts is primarily for research, preliminary exploration, or studies where the level of effort is unknown.

Other types of contracts provide for obtaining goods and services based upon established labor rates and contracts of last resort. These other contract types include:

- *Time-and-materials contracts.* These contracts reimburse the contractor for labor and the cost of materials in a negotiated composite rate for each hour of labor worked; the rate is all-inclusive of labor costs, overhead costs, and profit. Because the contractor has no positive incentive to maintain cost controls, the government should effectively monitor contractor performance. Use of these contracts is appropriate when the extent of the work is uncertain or cannot be reasonably predicted.
- *Labor-hour contracts.* These contracts are similar to time-and-materials contracts except there are no provisions for materials. These contracts reimburse the contractor on the basis of a fixed hourly labor rate that includes the cost of labor, overhead, and a profit factor; the only variable is the number of hours provided under the contract.
- *Letter contracts.* These contracts authorize contractors to immediately manufacture supplies or perform services when no other contract is suitable. These contracts require clauses limiting the government's liability.
- *Indefinite-delivery contracts.* These contracts allow for the purchase of goods and services through the use of multiple delivery orders and task orders. These are open contracts that do not have a predefined level or quantity of services.

Under the rules set forth in the simplified acquisition methods, agencies may obtain goods and services through purchase orders, blanket purchase agreements (BPAs), imprest funds, third-party drafts, and Standard Form (SF) 44, "Purchase Order–Invoice–Voucher."

- Purchase orders specify a fixed price for the quantity of goods and/or scope of services, with specified delivery dates and period of performance.
- BPAs provide a simplified purchasing method to fill anticipated repetitive needs for supplies and services through qualified sources of suppliers by which orders can be placed.
- Imprest funds and third-party drafts are similar to petty cash used in the commercial sector. These transactions are usually limited to \$500 and \$2,500 for imprest funds and third-party drafts, respectively. However, agency heads may approve different limitation levels based on agency needs and policy documentation.
- SF 44 is designed to authorize the purchase of goods and/or services when one is away from the administrative office and services and/or goods are needed. It is used rarely.

### **Responsibility for Contracts**

Several organizations in the Federal Government's legislative and executive branches have the authority or responsibility for financing, negotiating, awarding, funding, administering, and settling Federal contracts. The nature of authority or responsibilities exercised by these various organizations is briefly outlined next.

#### ***Congress***

Congress, through its authorization and appropriation committees, has the ultimate authority and responsibility for overall Federal procurement and grant policies. These policies appear in laws having government-wide applicability, and, at times, specific legislation applies to a single particularly significant procurement.

#### ***Cost Accounting Standards Board***

The Cost Accounting Standards Board (CASB), part of the Office of Federal Procurement Policy within the Office of Management and Budget (OMB), issues standards to achieve uniformity and consistency in the cost accounting principles adhered to by Federal contractors and subcontractors.

#### ***Government Accountability Office***

GAO is authorized to audit the expenditures of Federal monies spent under contracts, including reviews of agency procurement systems. These reviews are made internally at the Federal entity or externally at a contractor's location. GAO also has the legal authority to render binding decisions on Federal entities with respect to procurement actions, but a contractor may appeal these decisions in the courts.

#### ***General Services Administration***

The General Services Administration (GSA) is responsible for publishing and overseeing the Federal Acquisition Regulations (FAR) that describe the terms and conditions



of Federal procurements. FAR is a government-wide procurement policy. Agencies such as the Department of Defense (DoD) and the National Aeronautics and Space Administration (NASA) may monitor contracts pursuant to a tailored version of procurement regulations, but these tailored regulations are almost identical to the FAR published by GSA.

### ***Office of Management and Budget***

OMB issues government-wide regulations relating to Federal procurements, the most notable of which are the OMB cost circulars that, along with provisions of various titles of the U.S. Code, define types of allowable costs, unallowable costs, and indirect or overhead costs permitted or prohibited under Federal contracts and grants.

### ***Defense Contract Audit Agency***

The Defense Contract Audit Agency (DCAA), with over 4,000 auditors at more than 300 field audit offices throughout the United States, Europe, and the Pacific, is responsible for performing all contract audits for the DoD as well as several hundred Federal grants. These audits could include:

- Reviews of contractor and grantee cost estimates and price proposals.
- Audits of contractor or grantee costs for compliance with Federal allowable, unallowable, and indirect costs regulations.
- Reviews of contractor and grantee compliance with Federal cost accounting standards and other costing criteria, such as the OMB allowable and unallowable cost circulars.

DCAA may decline audit requests from the cognizant agency (the agency responsible for auditing the contractors). In these cases, the cognizant agency may contract with others to obtain the audit services.

### ***Individual Contracting Agencies***

Pursuant to the Budget and Accounting Procedures Act of 1950 and later laws, Federal Agencies must have in place procurement policies, procedures, and systems for: the solicitation and evaluation of contract proposals; to negotiate, award, and administer contracts; and to account for contract performance. An agency's systems of controls, accounting, and reporting must be sufficiently precise to permit monitoring of contract obligations, liquidation of these obligations, and the costing and disbursement of contract funds. The cognizant agency is held responsible for having the necessary audits performed.

## **FEDERAL PROCUREMENTS**

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Selected salient features of Federal procurement include the responsibilities, requirements, and processes discussed in the next sections.

**Players**

Not all contract award tasks or activities are resident within a single unit or function of a Federal Agency. The successful completion of a procurement action requires the collaboration and coordination of several various agency units. Some of these are outlined next.

***Program Office or Allottee***

The initiation or determination of need for contractor services generally originates with the responsible program management office, although functional offices (e.g., accounting, budget, data processing, human resources, and even the contracts office) might require contracted services or support. The originating office is expected to:

- Prepare a preliminary estimate of costs.
- Identify potential sources of supply.
- Prepare the formal procurement request.
- Monitor performance and accept delivery under the contract.
- At contract completion, recommend that the contractor be paid.

***Contracts Office or Procurement Section***

Actual contracting activities are generally centralized in the agency's contracts function. This function often is responsible for:

- Identifying prospective contractors.
- Issuing requests for proposals (RFPs) and invitations for bids (IFBs).
- Conducting negotiations with prospective contractors.
- Executing and awarding contracts.
- Administering the contracts.
- Settlement and close-out upon contract completion.

***Accounting Section***

The accounting section must confirm the availability of agency appropriations money for the contract in advance of procurement request (PR) approval. Additionally, this function:

- Formally obligates agency funds upon notification of contract award.
- Examines invoices related to contract terms and performance.
- Conducts prepayment "audits" of contractor invoices.
- Initiates formal accounting transactions to obligate, liquidate the obligations, expenditures, and payables, and provide ultimate payment related to each awarded contract.
- Compiles internal and external financial reports on awarded contracts.

- Prepare the schedule to request issuance of checks by the Treasury Department to the contractor.
- Perform the fiscal and budgetary accounting during and after expiration of the agency's appropriations.

### ***Contractor or Vendor***

The contractor or vendor must first submit a proposal or bid in response to the RFP or IFB. If successful, it negotiates contract terms and conditions and executes a contract with the Federal Agency. The contractor or vendor must then:

- Perform the agreed-upon services or deliver the contracted goods.
- Complete and file end-of-contract financial, property, and performance reports for final contract settlement.

### ***Treasury Department***

Actual checks or electronic fund transfers (EFTs) in payment of invoices submitted by contractors are issued by the Treasury Department upon receiving a request from the contracting agency to initiate payment to a contractor, unless the contracting agency has disbursing authority. In that case, the agency issues the payments to submitted invoices.

### **Process**

As noted, many Federal Agencies have the authority to issue and require adherence to their policies and regulations relating to Federal contracts. However, the design of a system of controls to meet the criteria of these agencies and to adequately protect the government with respect to procurements is the sole responsibility of the individual operating Federal Agency that issues the contract. Although the specific steps or details vary, most Federal entities have established procedures requiring:

- Preparation and approval of a *procurement request* or *authorization*, approved by the responsible program official and annotated to show that unobligated funds exist to meet the estimated amount of the intended procurement, all of which is done before prospective contractor sources can be contacted. For agencies that use commitment accounting, this results in an accounting entry to reserve the funds as a commitment.
- Determination as to whether a procurement is to be awarded from a *competitive selection* and whether the contract is ultimately awarded through advertising or negotiation. Competition may be obtained from a variety of Federal sources, including electronic media (e.g., Federal Business Opportunities [FedBizOpps]).
- A *formal review process* for the objective evaluation of all proposals, solicited and unsolicited, received by the agency to ensure compliance to prescribed negotiation practices.

- Conduct of a *survey* or *review of contractor accounting and management controls systems* through on-site examinations of the contractors and consulting with other Federal entities with which the contractor has done business.
- The formal execution and *issuance of the contract*, with the timely notification to the agency fiscal function to permit prompt obligation of funds in an amount equal to the funded value of contracts.
- *Reporting*, on a periodic basis, of the rate of expenditures by the contractor as well as the quality and timeliness of contractor performance or deliveries, which often includes positive confirmation of the receipt and satisfaction of service or performance.
- *Prepayment audits* of invoices to ensure that:
  - Amounts, performance, and deliveries are consistent with negotiated contract terms.
  - Prompt and accurate payment is made of properly rendered invoices.
  - There is timely processing of all procurement transactions.
- Final settlement or *contract closeout* of any advanced money, government-furnished equipment, and property in a manner consistent with agency policy or contract conditions, and a final assessment of contractor compliance.
- Collection of an objective report on contractor performance during each performance period to be used in source selection evaluations, often stored in an automated Contractor Performance Assessment Reporting System (CPARS).

### **Accounting**

OMB has prescribed certain agency accounting criteria for the obligation, accrued expenditure, and applied cost of contract transactions relating to the acquisition of services and goods. Except when precluded by law, the contract accounting of Federal Agencies must be conducted in accordance with concepts set forth in OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*.

### **Obligations Incurred**

An agency's reporting of contracted obligations incurred for contracted services or support must comply with Section 1311 of the Supplemental Appropriations Act, which requires the existence of legal evidence of binding agreements, orders, or other legal liabilities prior to the recording and reporting of a contract obligation. OMB Circular A-11 sets forth the formal criteria for recognizing legal obligations. According to OMB, internal administrative commitments of funds and invitations to bid sent to prospective contractors must not be included in amounts the agency reports as obligations. These types of activities fail to meet the criteria of Section 1311 for valid obligations.

### ***Accrued Expenditures***

Expenditures for printing and reproduction, contractual services, supplies and materials, and equipment will accrue when a contractor, vendor, or other party performs the service or incurs costs. Tests of performance may be a physical receipt, passing of title, or constructive delivery. The constructive receipt criteria would apply when products or services are being provided according to the Federal entity specifications and the product or service is a nonstock item.

### ***Accrued Costs***

The reporting of accrued costs related to contracts, orders, and agreements is similar to the reporting of accrued expenditures, with some exceptions. For instance, according to OMB:

- *Applied costs* include depreciation and unfunded liabilities when such amounts are provided in the accounts of the agency.
- A net increase in inventories is an *accrued expenditure* but would not be an applied cost until that inventory is used.
- Conversely, a net decrease in inventories is an applied cost but not an accrued expenditure.
- For operating programs, a *change in capital assets* is not an applied cost, even though it is an accrued expenditure; the use or consumption (by depreciation or amortization) is the cost of a capital asset.

### **Key Forms**

Within a Federal entity, several forms are required to document a valid contract action. The more common forms encountered are identified next.

### ***Procurement Request and Authorization***

The PR represents the initiating document for a procurement. This record is completed by the program office determining that a need exists that cannot be met with the Federal entity's existing resources. (No accounting entry results from the preparation or issuance of a PR unless agencies use commitment accounting.)

### ***Request for Proposal or Bids or Quotes***

An RFP or IFB should identify or describe the following:

- Scope of work
- Period of performance

- Estimated level of resources required to conduct or perform the scope of work
- Type of contract to be awarded
- Special and general conditions applicable to the contract
- On some occasions, the estimated amount budgeted by the entity for the specific contract action (no accounting entry results from the preparation or issuance of an RFP/RFB/RFQ)
- Information required to be in the offeror's proposal
- Factors and significant subfactors that will be used to evaluate the proposal, and the relative importance of each

### ***Submitted Proposals or Bids***

Interested organizations respond to the RFP/RFB/RFQ by submitting proposals or bids describing how they would undertake to perform the scope of work, the type of resources that would be required to complete the work satisfactorily, and the amount of money required to provide the goods or services. (No accounting entry results from this phase of the contractual process.)

### ***Contract Document***

The award of a contract constitutes the legal binding obligation of the Federal entity. The contract, signed by the contractor and agency executives, describes:

- Negotiated scope of work.
- Performance period.
- Terms and conditions.
- Amount of the contract.
- Amount funded.

(A formal accounting entry is made to obligate a portion of an agency's appropriation balance for the amount of the contract or the funded amount, whichever is less.) When the amount of the contract is significantly in excess of the amount funded, the contract is said to be incrementally funded, limiting its liability to only the funded amount.

### ***Financial Expenditure Reports and Invoices***

Most Federal entities provide for progress or partial payments through the duration of the contract, with the amount of the payment dependent on the rate of incurred expenditures shown on periodic financial reports or invoices submitted by the contractor. (These documents are generally subjected to a prepayment audit and are the basis for supporting an accounting entry to liquidate the earlier obligation and record the accrued expense or costs of the contract.)

### ***Cash Advances***

Certain contractors (usually nonprofit organizations and non-Federal Government entities) receive an advance of funds. Advances can take one of two forms: (1) lump-sum or periodic advances, given to the contractor to cover operations for a specified time period, such as 30 or 60 days, and (2) letter-of-credit drawdowns. The letter-of-credit process is also a periodic funding that requires the existence of certain forms:

- An authorized *signature card* identifying the contractor's certifying officer, which is placed on file with the Treasury Department and the contractor's commercial bank or other designated disbursing organization.
- A *letter of credit* completed by the government entity and forwarded to the Treasury Department:
  - Identifying the Federal Reserve Bank or Treasury disbursing agent.
  - Identifying the contractor.
  - Establishing the total amount of the letter of credit and the periodic withdrawal limits.
  - Defining the time period for which the letter of credit will be available.
- A *request for payment* on the letter of credit prepared by the contractor, consistent with the letter of credit, to withdraw funds to finance the contract scope of work. This form requires a reconciliation of balances, withdrawals, and other letter-of-credit transactions and an identification of the program or contract for which funds are being withdrawn.
- The issuance of an *advance* at the time of contract award or the release of funds pursuant to the submission of a request for payment on a letter of credit constitutes a disbursement of funds, which is an advance that must be posted as an accounts receivable due the Federal entity. These advances are a reduction in the agency's fund balance with the Treasury.

### ***Schedule and Voucher of Payments***

The schedule and voucher of payments, whether a hard-copy form or an electronic facsimile, is the formal request by an agency to the Treasury Department to make payment (by checks, EFTs, or direct deposits) for specific amounts to identified contractors. The Treasury Department makes no distinction between payments made for services or for advances. This accounting is a responsibility of the individual entity, and the schedule represents the documentation in support of an agency's cash disbursements accounting entry.

## **PROCUREMENT AUDITS**

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A distinction generally exists between internal audits made of a Federal Agency's procurement functions and external audits made of the agency's contracts awarded to its contractors.

Audits of an agency's procurement functions (i.e., internal audits) could entail an examination of the policies, procedures, and practices by which the agency advertises, negotiates, awards, manages, monitors, finances, accounts, and ultimately closes out or settles contracts. Periodic audits of the procurement functions would more likely be made by Federal Inspectors General (IGs) or agency internal audit staffs, but such reviews and examinations could also be outsourced to independent consulting and accounting firms.

Exhibit 15.1 is a partial listing of the factors to consider in planning an audit of a Federal contractor or contract. Specific conditions and circumstances related to individual Federal contracts and grants may dictate that alternative tests be considered. If circumstances do not permit performance of the tests, the auditor must reflect this fact in the audit opinion.

### **Audits of Procurement Process**

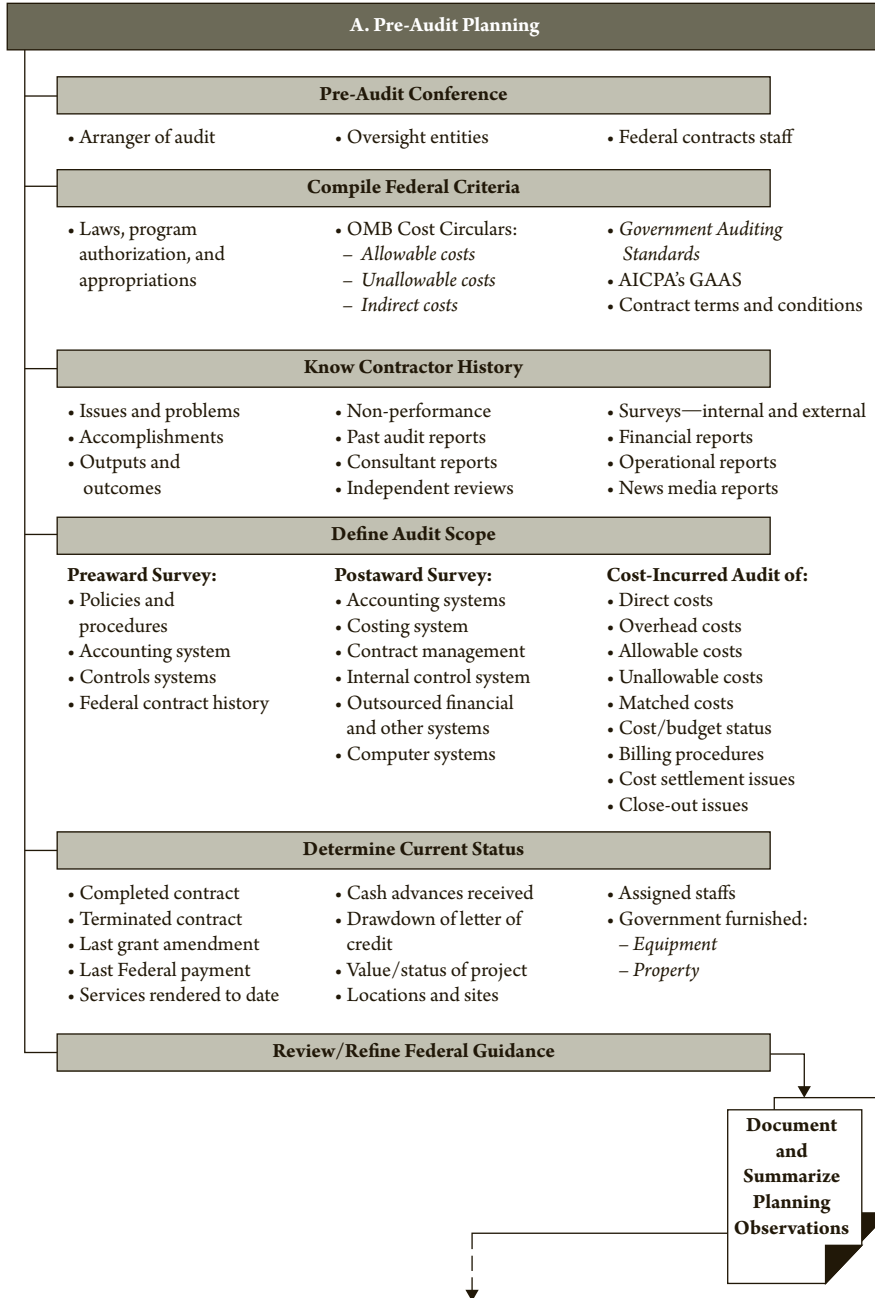
An agency's procurement process is subject to periodic internal audits to determine whether its program managers and contracting personnel are procuring the right services and goods at fair prices in accordance with agency policy and procedures and pursuant to the Federal acquisition regulations and other laws and OMB regulations.

### ***Audits with Varied Scopes***

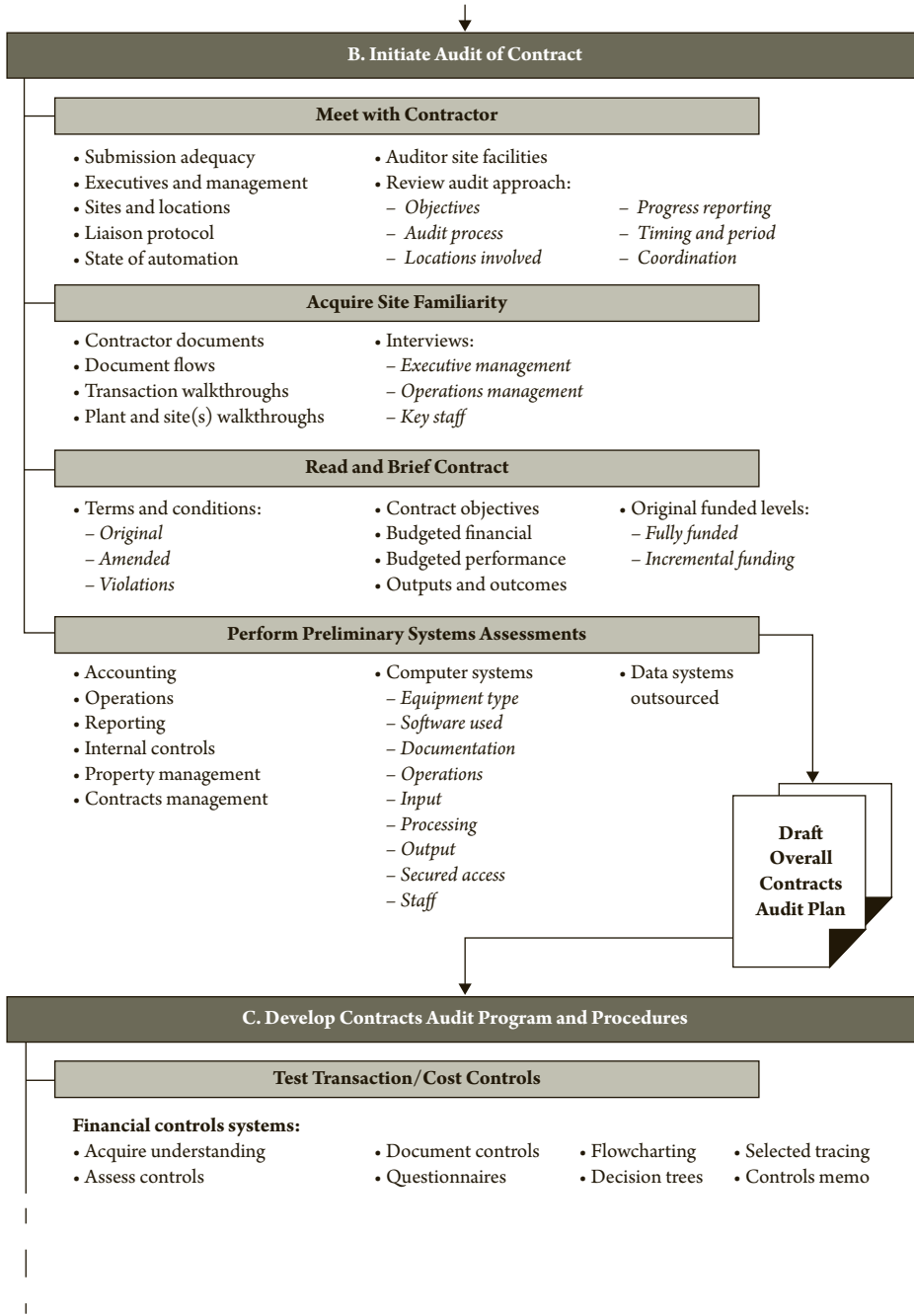
No uniform scope exists for internal audits of a Federal Agency's procurement process. Each audit is tailored to achieve the unique objectives and address the particular needs of that agency. The scope of an internal audit of a Federal Agency's procurement process could be broad and all-encompassing, blending aspects of a compliance audit, financial-related audit, and a performance audit; or the audit scope could be limited, concentrating on a single subject or area. Most likely, the audit will concentrate on one or a few issues that concern agency management, possibly including tests of one or more of these activities to:

- Assess the effectiveness of decisions reached in determining an agency's need for services, supplies, equipment, or property.
- Examine the manner and thoroughness with which lists of prospective contractors are compiled, vetted, and solicited.
- Ensure adherence to practices that will result in the maximum competition of competent, prospective contractors resulting in goods and services being procured at a competitive price.
- Test the relative completeness of bid and proposal evaluations and weightings applied in selecting the successful contractor.

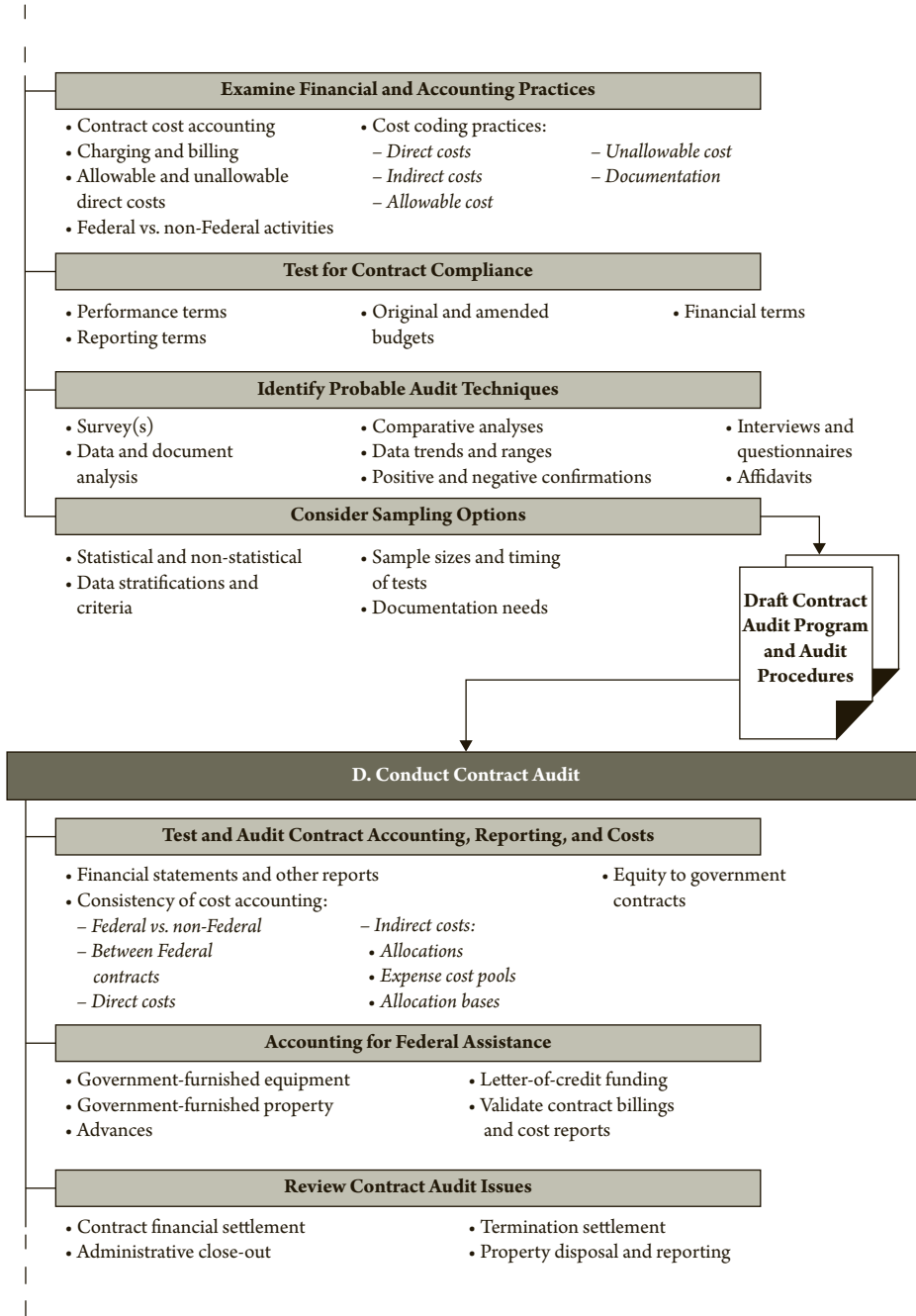




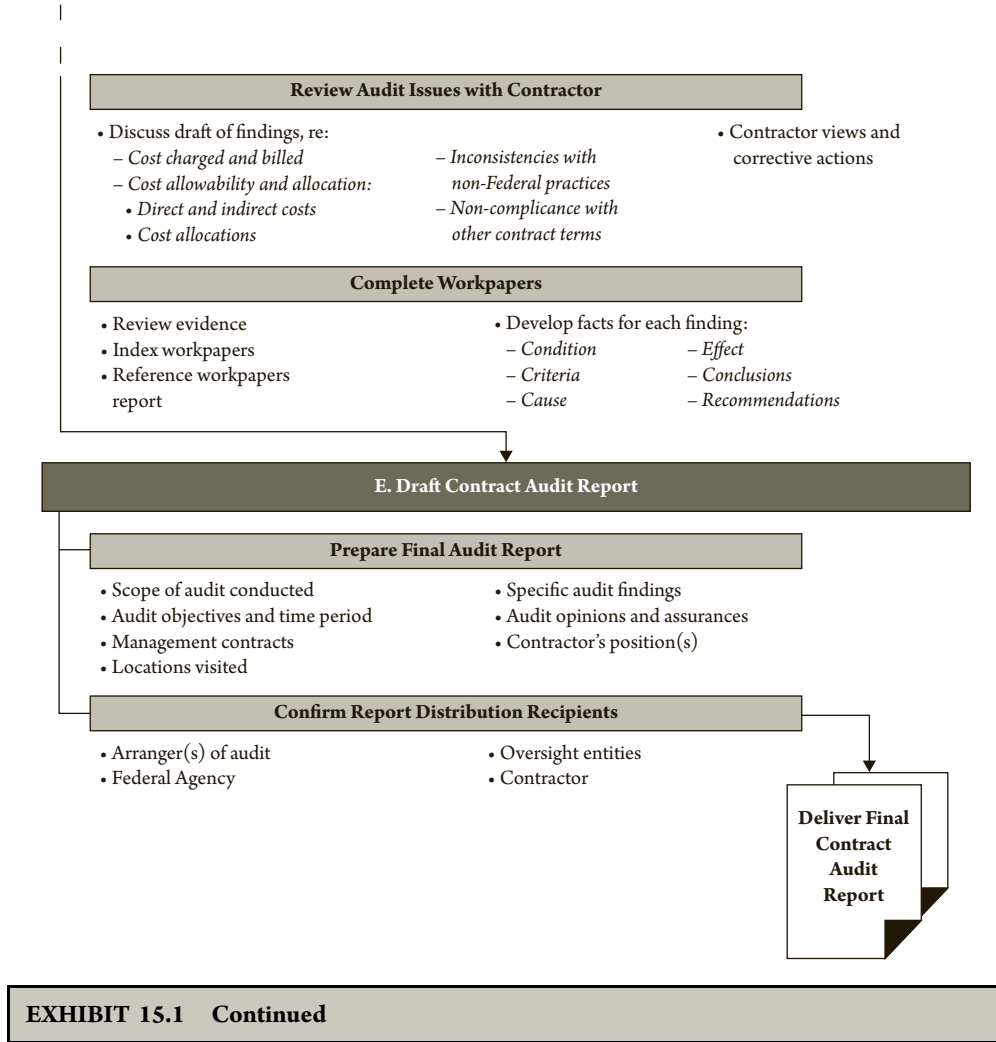
**EXHIBIT 15.1 Methodology for Audits of Federal Contracts**



**EXHIBIT 15.1 Continued**



**EXHIBIT 15.1 Continued**



**EXHIBIT 15.1 Continued**

- Assess the thoroughness of bid and proposal pricing reviews and cost analysis techniques.
- Review contract administration activity, including tasks to monitor contractor performance, contractor progress reports, invoice preaudits and payment approvals, controls over government-furnished properties (GFPs), contract closeouts, and final settlement practices.
- Assess adherence to regulations relating to contracting by small purchase orders, with particular emphasis on compliance with adherence to the dollar ceilings and repetitive award of such contracts to a single vendor.

An internal audit of a procurement process could appropriately be focused on non-financial administrative and management issues. Another internal audit could, with merit, be an examination of the contracting, financial, administrative, and monitoring systems that support an agency's contract activities. The dollar significance of government-furnished equipment (GFE) or government-furnished property (GFP) in a contractor's possession could warrant an audit of the manner in which the GFE or GFP is procured, acquired, stored, controlled, used, and disposed of.

Internal audits are often made at the procurement function's central location, but field and site visits are not uncommon to verify or confirm the existence of a condition, possibly involving the contractor's bid, performance, or financial activities.

### **External Contract Audits**

Audits and reviews executed in connection with Federal procurements generally encompass the activities discussed next.

### ***Contract Audits***

In addition to audits of an agency's procurement process (i.e., internal audits), audits are also made of non-Federal contractors (i.e., external audits). Although these audits are typically made by Federal IGs, internal audit staffs, and the DCAA, a significant number of these audits are also performed by independent accounting firms under contract to Federal and other governmental agencies usually the cognizant agency.

Contract audits are made of proposals and bids from prospective contractors who desire to compete for fixed-price and cost-reimbursement-type contracts. Contract cost audits are made to test the allowability or possible unallowability of costs claimed under cost-reimbursement contracts. These audits are typically focused on assessing the adequacy of a contractor's cost accounting systems and billing procedures, and appropriateness of its cost allocations to Federal and non-Federal activities.

Many audits are made of a contractor as an entity, but considerably more audits are made of individual contracts, particularly those of dollar significance, with performance scheduled over more than a single year. These Federal audits could be made by agency auditors who actually reside at the contractor's location or by a traveling Federal audit team that periodically visits the contractor. The reasons for contract audits vary but include issues such as these:

- Many contracts are awarded by negotiation, often without the benefit of competition, and result in somewhat less than a marketplace price determination.
- Cost-reimbursement contracts are audited to ensure that the contractor is reimbursed for only actual allowable and relevant costs and to identify and restrain incurrence and billing for exorbitant costs.
- The Federal Agency cannot audit the basic price of fixed-price contracts, but such contracts often contain terms that permit reviews of price adjustments, cost escalation readjustments, and incentive compensation.

- The quality of a contractor's property accountability policies and practices with respect to GFE may be assessed to ensure that Federal property is adequately safeguarded and applied only for purposes approved by the Federal Agency.

The authenticity of cost or pricing data submitted by a contractor must meet the requirements of the Truth in Negotiations Act.

### ***Types of Contract Audits***

Contract audits may be detailed, transactional-type financial audits of costs incurred and charged to a Federal contract. At times, the term *contract audits* more broadly includes pricing reviews, preaward surveys, postaward surveys, and detailed audits of costs of one or more contracts.

### **Pricing Reviews**

After proposals are received from prospective contractors, an agency may elect to have its auditors conduct a *pricing review* of elements of the proposed costs or price. A detailed pricing review might well include verification of the bidders' proposed costs for material, labor, other direct costs (i.e., travel, relocation, special equipment, computers, and so on), overhead burden, and general and administrative costs. Equally as important would be a validation of the bidders' bases for such estimates and, if possible, relating the proposed price to the bidders' performance on similar efforts.

### **Preaward Surveys**

Should a Federal Agency have limited experience with a prospective contractor who is otherwise deemed to be responsive and responsible, its auditors might make a preaward survey to generally assess the prospective contractor's systems of financial accounting, cost accounting, internal controls, and project/contract management policies and procedures. Inquiries could also be made of the experiences of other Federal Agencies in relation to the prospective contractor.

### **Postaward Surveys**

A postaward survey, if one is conducted, would occur within 90 days of contract award to a new contractor to ensure that the contractor has in place financial, administrative, and operational policies and procedures and that desired practices are employed for the contract.

### **Audits of Direct and Other Contract Costs**

Contract audits are made at the conclusion of shorter-term contracts and are made periodically of significant contracts requiring performance over more than one year. These audits would blend audit tests to assess compliance with general contract terms and conditions as well as performance and financial terms. Although the objectives of these

audits are dependent on the type of contract experience and issues or problems encountered, such audits often include audit tests of these areas:

- Costs incurred, charged to, and later billed to the contract
- Support documents and other evidence of compliance with performance and financial terms and conditions of the contract
- Reasonableness of costs claimed in relation to the expired contract period and desired or expected contract outputs and outcomes
- Appropriateness of cost accounting and cost allocations applied to the Federal contract in comparison to that employed for a contractor's non-Federal business and activities
- Comparison of proposed costs, to negotiated costs and to incurred costs to assess the overall efficacy of prices being paid by the Federal Agency.

### **OMB'S COMPLIANCE AUDIT SUPPLEMENT**

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OMB's *Compliance Audit Supplement* (the *Supplement*) provides guidance for audits of Federal contracts as well as grants and cooperative agreements.<sup>1</sup> Prior to the issuance of the *Supplement*, auditors of Federal contracts were required to search numerous sections of the Code of Federal Regulations (CFR), OMB circulars, the Federal acquisition regulations, and their agency's own procurement and contract policies in an effort to distill the Federal contract compliance concerns into an audit program. An analysis of several OMB circulars and bulletins covering contract policies, Federal laws, and regulations (the FAR, particularly) affecting the government's procurement of goods and services and the contracting policies and procedures of individual Federal Agencies reveals considerable similarity, duplication, and overlap. The OMB *Supplement* is an excellent single source for identifying Federal contracting policies, concerns, and issues insofar as they relate to contract audits.

OMB has stated that application of the *Supplement* will constitute a "safe harbor" for auditors with respect to the *nature* (i.e., what to audit) of audit procedures to apply. However, the *timing* (i.e., which months, periods, or accounts to test) and the *extent* (i.e., how much will be tested) depend on the auditor's judgment and on circumstances unique to the contractor or contract undergoing audit.

### **AUDIT ISSUES**

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This section focuses on audits of Federal contractors and individual contracts awarded to non-Federal entities, including state and local governments, corporate entities, academic

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<sup>1</sup> The OMB *Compliance Audit Supplement* emanates from the Single Audit Act and OMB Circular A-133. The *Compliance Audit Supplement*, along with current OMB circulars, is available on the Internet at [www.whitehouse.gov/omb/circulars/a133\\_compliance\\_supplement\\_2012](http://www.whitehouse.gov/omb/circulars/a133_compliance_supplement_2012).

institutions, utilities and authorities, and subsidiaries. Concurrent with its Federal activities, a non-Federal contractor may also provide services under contract to non-Federal activities.

These conditions, relationships, and circumstances may present difficulties when undertaking an audit of individual Federal contracts that could restrict the audit scope or be the basis for a qualified audit opinion. Some of these audit issues are outlined next.

### **Allowable, Unallowable, Indirect Costs**

Uniform Federal policy defines what the Federal Government has determined to be *allowable*, *unallowable*, and appropriate *indirect costs*. While OMB issued circulars to define these requirements, the circulars have been relocated to the CFR to provide a common and comprehensive location for Federal regulations. The circulars and the relocation citations include:

- OMB A-21, *Cost Principles for Educational Institutions*, relocated to 2 CFR Part 220
- OMB A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, relocated to 2 CFR Part 225
- OMB A-122, *Cost Principles for Non-Profit Organizations*, relocated to 2 CFR Part 230
- 48 CFR Part 31, *Contract Cost Principles and Procedures*

These circulars describe selected cost items, allowable and unallowable costs, and standard methodologies for calculating and allocating the indirect costs of non-Federal contractors. These cost policies are limitations on the amounts that may be reimbursed or recovered under a Federal contract. The cost principles articulated in each of these circulars are substantially similar, but some differences do exist, due mainly to the nature of the recipient organization, the nature of programs administered, and the breadth of services and operations of some grantees but not others. Further, the policies closely parallel the cost provisions in the government's FAR.

A general policy relating to charges, reimbursements, billings, or payments to non-Federal contractors is that these costs must "be determined in accordance with GAAP [generally accepted accounting principles], *except* as otherwise provided for in CFR." The emphasis on the word *except* is of particular significance to auditors of Federal contract and grant programs because there are many significant exceptions.

Characterization of costs as allowable or unallowable does not imply that such costs are unnecessary, unreasonable, or illegal. The terms *allowable* or *unallowable* mean only that the cost does not meet the government's criteria for allowability. In most instances, the contractor could not function without the activities supported by the so-called unallowable costs.

Several policy statements (laws, regulations, OMB circulars, agency rules) detail categories of costs necessary to operate the non-Federal entity that are considered to be



unallowable as a matter of declared Federal policy. Some examples of costs declared as unallowable include those listed next.

- *Costs unallowed per public policy:* Write-off of uncollectible receivables; accrued cost for contingent liabilities; state and local government taxes; advertising cost; cost of idle facilities; lobbying costs; financing costs; donations; and contributions. The accounting and reporting of these costs are mandated and appropriate under GAAP but are classified as unallowable by the Federal Government for charges to its contracts.
- *Costs unallowed unless “funded” in advance of billing to the Federal Government:* All pension costs of government employees; postretirement health and other benefit costs due to Government employees; and self-insured liabilities and costs are deemed unallowable until actually funded. The accounting and reporting of these incurred but not paid costs are required by and appropriate under GAAP but are classified as unallowable by the Federal Government as charges to its contracts.
- *Costs unallowed unless approved in advance:* Cash drawdown in excess of three days; employee relocation costs; recruiting costs; subscriptions costs; professional membership fees; and purchase of capital assets. The accounting and reporting of these costs are mandated and appropriate under GAAP but are classified as unallowable by the Federal Government for charges to its contracts, unless advance approval was obtained.

Unallowable costs may not be charged to, claimed under, or billed directly or indirectly to any Federal contract, grant, or other program of Federal assistance. If so done, such costs would be an audit finding reportable as a *questioned cost* by the auditor.

## **ALLOWABLE/UNALLOWABLE COST CRITERIA**

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The audit tests to assess compliance with Federal procurement policy and Federal allowable cost criteria require the auditor to test direct and indirect costs charged to or claimed under a Federal contract and to verify that the cost elements meet each of several allowability cost factors.

To be allowable under Federal costing criteria, direct and indirect costs charged or claimed by a contractor must meet each of these ten criteria:

1. Be *necessary and reasonable* for the proper and efficient performance and administration of Federal awards.

*Necessary costs* are costs required, implicitly or explicitly, by law, regulations, and the Federal contract agreement to support the program outlined in the

Federal contract. Necessary cost criteria should be assessed from the view of the purpose, timing, amount, authorization and approval, and the ultimate accounting of charged costs in relation to the performance period of the contract.

*Reasonable costs* are costs that are reasonable if, in nature and amount, they do not exceed that which would be incurred by a prudent person under circumstances prevailing at the time the decision was made to incur the cost. Determination as to the reasonableness of costs must give consideration to the following questions:

- Do the claimed costs exceed the type generally recognized as ordinary and necessary for the operation of the contractor or attainment of the performance or objectives outlined in the executed Federal contract?
  - Do the claimed costs exceed restraints on spending or cost requirements imposed by sound business practices, presence of arm's-length bargaining, terms of Federal and other laws, regulations, and terms, or as conditions of the Federal contract?
  - Do the claimed costs exceed market prices for comparable goods or services?
  - Do the claimed costs significantly deviate from established practices in a manner that unjustifiably increases the cost to the Federal contract?
2. Be *allocable* to Federal awards under the provisions of FAR cost principles.

*Allocable costs* are costs that are allocable if the cost is directly allocable to a particular cost objective or if the goods and services involved are chargeable or assignable to such cost objectives in accordance with relative benefits received. OMB requires that determination of *allocability* of costs give consideration to:

- All activities that benefit from a unit's indirect cost, including unallowable activities and services donated by third parties, receive an appropriate allocation of indirect costs.
  - Unless otherwise permitted in writing, any cost allocable to a particular Federal contract or cost objective may not be charged to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by law or terms of Federal awards, or for other reasons.
  - Where an accumulation of indirect costs will ultimately result in charges to a Federal contract, a cost allocation plan will be required, similar to those outlined in CASB standards or the appropriate OMB cost circulars.
3. Be *authorized* and *not otherwise prohibited* under any Federal, state, or local laws or regulations.
4. *Comply* with any limitations or exclusions set forth in the FAR, cost principles in OMB circulars, terms and conditions unique to the Federal contract, or other governing regulations regarding types, amounts, or limits on cost items.
5. Be in *conformance with policies, regulations, and procedures* that apply uniformly to both Federal and non-Federal contracts and awards and to Federal and

non-Federal activities of the non-Federal entity receiving assistance under a Federal contract.

6. Be accorded consistent cost accounting treatment.

*Consistent cost accounting treatment* means that costs may not be assigned to a Federal award as a direct or indirect cost if any other cost has been incurred for the same purpose, in like circumstances, and has been allocated to the Federal award directly or, in part, indirectly. The consistency requirement relates to the uniform accounting and charging of costs to both Federal and non-Federal activities of a contractor between fiscal reporting periods.

7. Be determined in accordance with GAAP, *except* as otherwise provided for in OMB cost circulars.
8. Be *not* included as a cost or used to meet *cost sharing or matching* requirements of any other Federal award in either the current or prior period, except as specifically provided by Federal law or regulation. This restriction prohibits a contractor from claiming direct or indirect costs that were charged to the Federal Government under one Federal agreement to meet a cost-sharing or cost-matching cost requirement of another Federal agreement.
9. Be net of all applicable credits.

*Net of applicable credits* refers to receipts or the reduction of expenditure-type transactions that offset or reduce expense of items charged to Federal contracts as direct or indirect costs (e.g., purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebate, or other price adjustments). In applying costs net of applicable credits, the allocability of net costs must give consideration to:

- The extent that such credits relate to allowable costs, the credits must be applied to the Federal award as a cost reduction or cash refund, as appropriate.
  - Amounts of any credits should be recognized in determining indirect cost rates or amounts to be charged to Federal awards.
10. Be adequately *documented*.

Audits of direct and indirect costs and matching contributions claimed or charged must be tested to support documentation that identifies or relates to the amount, timing, and purpose of transactions to the specific Federal contract. For example, the timing of the transaction must be within the contract period. In most instances, transactions preceding or following contract award are not allowable in the absence of specific approval by the Federal Agency.

Supportive documentation, as defined in literature of GAO and the AICPA, includes:

- *Accounting records of original entry*. Examples include journals, registers, ledgers, manuals, worksheets, and support for cost allocations. Alone, though, these types of accounting data are not sufficient supporting documentation.

- *Corroborating evidence.* Examples include canceled checks, invoices, contracts, grants, minutes of meetings, confirmations, and other written statements by knowledgeable personnel, information obtained by auditor inquiry, observation, inspection, personal examination, and other information developed by, or available to, the auditor.
- *Independent tests* must be made by the auditor of underlying data and records and include analyses, reviews, retracing procedural steps of the financial process, auditor recalculations, and performance of reconciliations of any cost allocations.

In audits of Federal contracts, the auditor must question and report to the Federal Agency for resolution claims or charges to the contract that are not sufficiently documented or supported or about which the auditor is unable to satisfy him- or herself by other evidential means as to the propriety and allowability of costs.

The OMB *Supplement* identifies ten procurement compliance regulations, noncompliance with which could have a direct and material effect on the accounting, charging, and billings to Federal contracts. If the contract is materially significant to the contractor, noncompliance under a Federal contract might well affect the contractor's overall financial statements. The compliance policies associated with individual contracts and of importance to contract audits are listed next.

1. *Costs charged to government: allowable, unallowable, direct, and indirect costs.* Dating to the middle of the last century, it has been Federal Government policy that the government will permit only certain direct and indirect costs to be claimed by and reimbursed under Federal contracts. Federal money may not be claimed or paid for any direct or indirect costs defined as unallowable by Federal policy. OMB has provided these definitions of direct and indirect costs:
  - *Direct costs* are those that can be identified specifically with a particular final cost objective. Typical direct costs chargeable to Federal contracts include employee compensation, cost of materials, equipment if specifically approved, and travel expenses subject to Federal limits.
  - *Indirect costs* are those (a) incurred for a common or joint purpose benefiting more than one cost objective and (b) are not readily assignable to the cost objectives specifically benefited, without an effort that is disproportionate to the results achieved. To facilitate equitable distribution of indirect expenses to the cost objectives served, it may be necessary to establish a number of pools of indirect costs within the contractor. Indirect cost pools should be distributed to benefited cost objectives on bases that will produce an equitable result in consideration of relative benefits derived. Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality, where such accounting treatment for that item of cost is consistently applied to all cost objectives.

2. *Equipment, real property.* The title to equipment acquired by non-Federal entities with Federal monies could remain with the non-Federal entity or with the Federal Government. Here, *equipment* is defined as tangible, nonexpendable property with a useful life of more than one year and an acquisition cost of \$5,000 or more per unit.
3. *Matching contributions.* Matching requirements, in kind or other, often require examination of the terms and conditions of the individual contract. Matching requirements are often specific as to the *amount, type, timing, and purpose* of match that is permissible. For example, if the agreed-upon match was to be cash, donated labor, or any other type of contribution, free or paid, it would be unallowable. Also, there may be a requirement that the match be provided within a certain time period; compliance in a later period would have to be reported.
4. *Availability of program funds.* Legislation for all Federal appropriations and other financial assistance places limits on the *amount* of funds being provided, the purpose for which the funds are provided, and a *time* period (or use period) after which the authority to spend the Federal monies lapses. (OMB Circular A-102, *Grants and Cooperative Agreements With State and Local Governments* (10/07/1994) (further amended 08/29/1997), the “common rule,” should be consulted for additional guidance on this compliance requirement.)
5. *Procurement, suspension, debarment.* Presidential executive orders and Federal regulations prohibit Federal Agencies from contracting with or subcontracting to parties that have been suspended or debarred or whose principals are suspended or debarred.
6. *Program income.* *Program income* is the gross income directly generated by the Federal project during the contract period (e.g., fees earned for services, rental income, sale of commodities or items fabricated under the program, payment of principal, and interest on loans made from Federal funds). Unless otherwise specified by the Federal Agency, program income shall be deducted from program outlays.
7. *Reporting.* Recipients of Federal contracts must use prescribed standard forms for financial, performance, and special reporting. Auditors must confirm that controls have been implemented to ensure that reports, claims for advances, and reimbursements are supported by the same books and records from which the entity’s financial statements were prepared. Tests must be made ensure submitted reports, claims for advances, and reimbursements are supported by underlying documentation and appropriate corroborating evidence.
8. *Special tests and provisions.* Laws, regulations, provisions of contracts, and grants contain requirements for special tests. The auditor must review the specific terms and conditions of the contract since the contract could contain conditions warranting special examination. The axiom of the legal profession applies equally to contract audits: *When all else fails, read the contract.* There is no substitute for

examining the terms and conditions of specific contracts, bond covenants, terms of loans, loan guarantees, and so on under which money or financial assistance is provided to support contracts to non-Federal entities.

9. *Activities: Allowable, unallowable.* Public monies may be used only for those activities allowed by law or regulation. Congress determines that certain organizations, groups, or individuals are to be beneficiaries of funding provided under particular Federal legislation. The law will also define the qualifying conditions and the benefits to be conferred. Permitted and prohibited activities must be identified, and audit tests made, to ensure that Federal monies are used to support only those activities permitted by law or regulation. Audit tests must be made to ensure that Federal monies were used to support only those activities permitted law or regulation.
10. *Cash management: advance funding of government programs.* For some contractors, forms of advance funding exist (e.g., lump-sum or total advance of required Federal funding; advances made at designated points during the contract period; or periodic drawdowns under a prearranged letter-of-credit procedure arranged between the contractor, the U.S. Treasury, and a local commercial bank). Under the Cash Management Act, a contractor's procedures for drawing down Federal funds must minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by the contractor. Historically, the cash balance could not be in excess of three business days.

When deciding whether to test a compliance requirement, the auditor must conclude whether (1) the requirement does or does not apply to the contract and (2) noncompliance with the requirement could or could not have a material effect on the contract. Chapter 7 of *Government Auditing Standards* (Yellow Book), "Reporting Standards for Performance Audits," provides guidance for the desired narrative-type audit reports and should be consulted before undertaking an audit of Federal contracts. Further, the guidance in Chapter 7 is part of the criteria used by Federal IGs and GAO in assessing the adequacy of the contract audit.

## GRANT AUDITS

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For the Federal Government, expenditures under grants-in-aid are very significant. Funds are expended by grants to purchase or support a wide variety of services, including purchases of equipment, real and consumer-type properties, supplies, and conduct of research, to mention a few of the purposes for which grants are issued. Amounts spent under grants greatly exceed amounts spent on other items in the budgets of many agencies. Congress monitors major grant programs closely, agencies track financing and operations under grant instruments, and, at times, the print and other news media provide extensive and detailed coverage of grants, particularly if there is a hint of fraud, waste, or abuses.

## Grants Defined

Since the 1960s, the definition or nature of the Federal grant has evolved from an endowment or outright gift of monies, to today, where many recipients of Federal grants operate programs, perform services, and render technical assistance on behalf of the Federal Government. Generally, a Federal grant may be defined as:

money or property in lieu of money paid or furnished by the Federal Government to a grantee under a program that provides financial assistance to the grantee or through the grantee to a constituency defined in law by Congress. Not included in this definition would be other types of Federal financial assistance, such as loans, loan guarantees, revenue sharing, and forms of insurances.

## Grant Types

In practice, the terms and conditions of grants may be indistinguishable from those of Federal contracts, as both contracts and grants are legally binding instruments between the Federal Agency and its contractors and grantees. At times, an instrument considered to be a contract by one Federal Agency may be accounted for as a grant by another. A variety of descriptors are applied to grants; some of the more common classifications are discussed next.

- *Formula grants*, by law, have a mandated funding level for identified types of grantees only, with little or no discretion being exercised by the Federal grantor. Formula grants could include allocations of money to states and their subdivisions for activities of a continuing nature, not confined to a specific project.
- *Project grants* resemble contracts because Federal grantors agree to pay the grantee for services, performance, or the completion of a project. These grants for projects with fixed or known periods could include research and training grants, planning and demonstration grants, technical assistance grants, and construction grants.
- *Block grants*, which are intended to consolidate funds for broad purposes into a single funding action, are typically issued to state or local governments with minimal or less expenditure restrictions from the Federal grantor.
- *Noncompetitive grants* may be awarded to all applicants meeting specified legal or other congressional criteria.
- *Competitive grants* may be awarded to a selected number of grantees having similar qualifying characteristics after an evaluation of proposals, in a manner similar to that used for competitive contract awards.
- *Recovery grants*, which are a result of grants issued under the American Recovery and Reinvestment Act of 2009 (Recovery Act), are unique in that they require Federal Agencies to implement certain activities for awarding and overseeing funds to enhance accountability and transparency of the funds issued under the Recovery Act.

As is evident from these definitions, the categorization of grants by groups is not a mutually exclusive ranking, nor are the descriptors applied uniformly across Federal Agencies. In practice, a grant award could conceivably fall within two or more of these categories.

### **Responsibility for Grants**

Several organizations share the responsibility for award, administration, and settlement of Federal grants. The nature of authority or responsibilities exercised by these organizations is outlined next.

#### ***Congress***

Congress, through its authorization and appropriation committees, has the ultimate authority and responsibility for Federal grant policies. These policies appear in laws having government-wide applicability as well as in specific legislation applicable to individual granting agencies. Legislation applicable to individual agencies contains specific congressional policy and, at times, procedural directions concerning the award and administration of a grants program.

#### ***Government Accountability Office***

GAO is authorized to audit the expenditures of Federal monies spent under grants. In the exercise of this authority, GAO may review systems of Federal Agencies relating to grants award and administration and the accounting and internal controls in support of these types of agreements. These grant reviews are made both at the Federal entity level and at contractor and grantee locations.

#### ***Office of Management and Budget***

OMB issues government-wide regulations relating to grant awards. For the past several years, OMB has relocated many of the OMB circulars related to grants to Title 2 in the Code of Federal Regulations (2 CFR), subtitle A, chapter II parts to provide a central location for Federal Government policies on grants. The CFR defines types of allowable and unallowable costs and indirect or overhead costs that are permitted or prohibited. The remaining circular, OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations* defines requirements for the audits of grant recipients. Applicable 2 CFR and circulars are listed next.

- 2 CFR Parts 215 and 220, *Cost Principles for Educational Institutions* (OMB Circular A-21), sets forth the allowable, unallowable, and indirect cost principles for contracts with educational institutions.



- 2 CFR Part 225, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87), sets forth the allowable, unallowable, and indirect cost principles applicable to state, local, and Indian tribal governments.
- 2 CFR Part 230, *Cost Principles for Non-Profit Organizations* (OMB Circular A-122), sets forth the allowable, unallowable, and indirect cost principles for nonprofit organizations.
- OMB Circular A-133 sets forth requirements for Federal Agencies to perform audits of Federal grant award recipients to promote consistency.

OMB has issued specific guidance to Federal Agencies issuing recovery grants to enhance the accountability and transparency of the Recovery Act funds. OMB Memorandum M-09-15, *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, provides guidance to Federal Agencies to facilitate accountability and transparency objectives of the Recovery Act. OMB provides guidance for merit-based decision making in awarding funds and issuing funds for projects that provide long-term public benefit and economic growth in line with policy.

### ***Individual Federal Grantor Agencies***

The Budget and Accounting Procedures Act of 1950 and later laws require the head of each Federal entity to establish and maintain an adequate system of accounting and internal controls over grant assistance programs. Pursuant to the act and other legislation, Federal entities have designed procedures relating to the solicitation and evaluation of grant proposals; negotiation, award, and administration of grants; and accounting for all phases of grant performance. It is critical that an agency's systems of controls, accounting, and reporting be sufficiently precise to permit: monitoring of grant obligations, liquidation of these obligations, and the costing and disbursement of funds under these agreements. The systems of controls, accounting, and reporting for contract and grant awards generally require the coordination of numerous organizations of the awarding Federal Agency. In addition, the Recovery Act establishes enhancements to the requirements for awarding and overseeing the funds, including awarding grants and required reporting for jobs and fund use.

### **Controls for Grants-in-Aid**

Federal organizations such as GAO, OMB, and GSA have some authority and responsibility to issue and require adherence to their government-wide policies and regulations relating to contracts and grants. However, the actual design of systems of controls, accounting, and reporting to protect the government is the sole responsibility of individual

Federal granting agencies. The details vary, but most Federal entities have established operating policies and procedures requiring that:

- A grant authorization is to be approved by the responsible agency official and annotated, in advance, to show that sufficient appropriated funds exist to meet the estimated amount of the anticipated grant.
- If grants may be competitively awarded, a formal review process will exist for the objective evaluation and ranking of grant proposals received by the agency, both solicited and unsolicited.
- The issuance of a grant with the timely notification to the fiscal function permits prompt obligation of funds in an amount equal to the funded value of the grant.
- Periodic reporting of expenditures and performance must be made to grantees, with formal agency acknowledgment of grantee performance.
- Settlement by grantees of advances of money and drawdowns under letters of credit must comply with Federal policy and the individual grant conditions.
- There exists periodic assessment of the extent to which the purpose or objective of the grant is being achieved and that the required accounting and management control systems are in place and operating effectively.
- There is compliance with specific conditions and provisions for required matching or cost sharing or in-kind contributions by grantee recipients.
- There is timely payment of grant liabilities, prompt settlement and close-out, final accounting, and reporting at the conclusion or termination of the grant program.
- A final audit of the grantee must take place, with the Federal Agency retaining the right to recover appropriate amounts after considering audit recommendations and questioned or disallowed costs identified during the audit.

### ***Grants-in-Aid Process***

For Federal Agencies with the authority to operate grants-in-aid programs, the grants management process requires formal authorizations and approvals for anticipated grant awards, the execution of specific forms to document the grants award process, establishment of the controls, and performance of the accounting for each grant awarded. Identification of the types and purposes of various support documentation is essential to auditing an agency's grants-in-aid program. For example:

- An agency's grantor program office establishes operating policies and procedures to implement a grants-in-aid program to provide assistance to the eligible recipient constituency cited by Congress in the *authorization and appropriation* legislation for the program.
- The agency's grants director, possibly a designated *allottee*, possesses budgetary authority to approve and fund grantee selections and later execute grants.

- The responsible Federal Agency might issue a notification to the public in the *Federal Register*, grants.gov, and other *announcements* describing the grants program, the eligible constituency, and the procedures for applying for the assistance to solicit applications for grants. (Some grant-in-aid processes may forgo the formal application phase, depending on the program's enabling legislation.)
- Applications for grants assistance, if required, are reviewed on receipt, critiqued for compliance with law, and approved, and a formal *grant agreement* is executed with grantees that is legally binding between an agency and its grantees, pursuant to Section 1311 of the Supplemental Appropriations Act.
- The receipt and acceptance of services, goods, or assistance by a grantee often must be formally monitored and acknowledged by the appropriate agency personnel.
- *Financial expenditure* and *operational reports* are provided by the grantee for reimbursement of expenses or in support of earlier advances or letter-of-credit drawdowns provided in anticipation of the reported expenditures.
- There are *prepayment* audits of invoices to ensure that amounts, performance, and deliveries are consistent with negotiated grant terms; prompt and accurate payment is made of properly rendered invoices; and there is timely processing of all procurement transactions.
- There is final settlement or *grant closeout* of any advanced money, government-furnished equipment, and property in a manner consistent with agency policy or grant conditions, and a final assessment of grantee compliance.

Not all grant award tasks or activities are resident within a single unit, function, or activity of a Federal Agency. Rather, the completion of a grant action requires collaboration and coordination between:

- *Grantor program office and allottee.* For new programs, the Federal grantor's program office is responsible for informing the congressionally targeted constituency of the Federal assistance program. This office is often responsible for conducting negotiations, when required, with prospective grantees; executing and awarding the grants; administering the grant; monitoring periodic financial and performance reports; and settlement and closeout at completion of the grant.
- A *grant management office* may exist outside of the grantor program office to maintain a separation of duties from the program office by providing policy and procedure development, award file management, financial oversight, and closeout support.
- *Accounting section.* This section must confirm the availability of agency appropriations money for grants in advance of grants approval. Additionally, this function performs the agency's accounting to record a commitment to reserve the available funds obligated for each grant awarded, liquidate the obligation when services are performed; and process the expenditures, payables, and ultimate

disbursement transactions related to each grant. The accounting section might also: compile internal and external financial reports on grants; prepare the schedule to request issuance of checks by the Treasury Department to grantees; and perform the fiscal and budgetary accounting during and after expiration of the agency's appropriations.

- *Grantee.* The grantee may have to prepare and submit a grant application, negotiate terms and conditions of the prospective grant, and execute a legally binding grant with the Federal Agency. Federal grants could be funded by periodic advances of cash to the grantee, permitting the grantee to draw down cash under a Federal letter of credit, or reimbursing the grantee on the basis of reports reporting the expenditures incurred for the Federal grant program. Each grantee must perform services or operate the agreed-to grant program; periodically complete and submit financial and performance reports to the Federal grantor; and compile end-of-grant financial, property, and performance reports to formally settle and close out the grant.
- *Treasury Department.* Actual checks or other types of funds transfer in payment for a grantee performance are issued by the Treasury Department upon receiving a request from the Federal grantor agency that a check be issued or direct deposit made to a named grantee unless the issuing agency is authorized to make disbursements, as DoD is.

### Events Requiring Accounting Entries

OMB has prescribed certain criteria for the incurring of financial obligations for awarded grants, the accruing of expenditures reported by grantees, and the accounting for costs of grant transactions. The accounting of grants-in-aid by Federal Agencies must be in accordance with the concepts set forth in OMB Circular A-11.

- *Record only valid obligations.* An agency's reporting of obligations incurred for Federal grants-in-aid programs, according to Section 1311 of the Supplemental Appropriations Act, requires that there be legal evidence of a binding agreement prior to the recording and reporting of obligations for grants. OMB Circular A-11 sets forth the formal criteria for recognizing formal grants-in-aid obligations. According to OMB, internal administrative commitments of agency funds and invitations to apply for Federal assistance sent to prospective grantees are not legally valid obligations. These and other type activities fail to meet the criteria of Section 1311.
- *Accrue grant expenditures regardless of when paid.* Expenditures for grants accrue when the grantee reports performance in accordance with the terms and conditions of the grant program. The expenditures accrue and a liability to the grantee is created by the grantee's performance. The accounting for the cash disbursed in

payment or reimbursement to the grantee may delay performance by weeks or even months, unless the grantee has received an advance or has withdrawn funds under a letter of credit.

The more common forms used by Federal Agencies when awarding and administering grant programs include several of those identified next.

### ***Grants Authorization***

The program authorization is a formal authorization for the grants program and approval to incur obligations on behalf of the Federal Government. Within the Federal Agency, this form may be executed by the head of the agency or, more often, by an official, frequently the agency's designated program allottee. The grants program authorization serves as the basis to allot a portion of the agency's appropriation to the grants-in-aid program.

### ***Grant Applications***

Repeat grantees of continuing grants-in-aid programs may be permitted to simultaneously submit an operating budget with the next year's financial plan, which, if approved, becomes the grantee's funding application for that year. A new grants-in-aid program might be required to request grants applications from the constituency identified by Congress in the programs authorization and appropriation legislation. Grant applications typically identify or describe these areas:

- Nature of the grants program
- Number and type of constituents to be serviced
- Period of performance
- Budget or estimated level of financial and other resources required to operate the grant program
- General and special conditions applicable to the grants-in-aid program or the individual grant.

No accounting entry results from receipt of a grants application.

### ***Grant Agreement***

The award of a grant constitutes the legally binding obligation of a Federal entity. The grant agreement typically signed by a grantee and the designated agency executive describes the scope of the grant services, performance period, terms and conditions, the amount of the grant, and the amount funded. When the face amount of the grant is in excess of the amount funded by the Federal Agency, the contract is said to be incrementally funded. An incremental funding limits the Federal Agency's liability to the funded amount. (At this stage, an accounting entry is made to formally obligate a portion of an agency's

appropriation balance for the lesser of the face amount of the grant or the incrementally funded amount.)

### ***Expenditure Reports***

Most grants-in-aid programs require that grantees submit periodic progress reports (financial and/or performance) to document grant funds received earlier as advances, letter-of-credit drawdowns, or requests for reimbursement of grant expenditures. (These reports are generally subjected to a prepayment audit and are the basis to support an accounting entry to liquidate earlier obligated amounts and record the program's accrued expense.)

### ***Cash Advances***

Most Federal grantees, usually nonprofit organizations and non-Federal Government entities, receive an advance of grant funds. Advances can be made in two forms: lump-sum or periodic advances given to the grantee to cover operations for a specified time period or letter-of-credit drawdowns. The letter-of-credit process is a periodic funding process that requires the existence of certain forms, including:

- An authorized *signature card* identifying the grantee's certifying officer that is placed on file with the Treasury and the grantee's commercial bank or other designated disbursing organization.
- A *letter of credit*, completed by the government entity and forwarded to the Treasury, identifying the Federal Reserve Bank or Treasury disbursing agent and the grantee, establishing the total amount of the letter of credit and the periodic withdrawal limits, and defining the time period for which the letter of credit will be available.
- A *request for payment* on letter of credit is prepared by the grantee, consistent with the letter of credit, to withdraw funds to finance grantee performance. The form requires the reconciliation of balances, withdrawals, and other letter of credit transactions and an identification of the associated grant program or grant for which funds are withdrawn.
- The issuance of an advance at the time of grant award or the release of funds pursuant to the submission of a request for payment on a letter of credit constitutes a *disbursement of funds*, which is an *advance* that must be posted as an accounts receivable due the Federal entity.

### ***Schedule and Voucher of Payments***

The voucher and schedule of payments, whether a hard-copy form or an electronic facsimile, is the formal request by the Federal grantor agency to the Treasury Department to make payment (by checks, EFTs, or direct deposits) in specified amounts to identified grantees. The Treasury makes no distinction between payments made for performance or

for advances. This accounting is a responsibility of the Federal entity, and the schedule merely represents the documentation in support of an agency's accounting entry for its cash disbursements.

### **Cooperative Agreements**

Cooperative agreement transactions and grants are accounted for in a similar manner. The cooperative agreement instrument was initially defined in the Federal Grants and Cooperative Agreement Act of 1977. Under this legislation, Congress attempted to distinguish among contracts, grants, and cooperative agreements by identifying the conditions under which each instrument was to be used.

- A *contract* is to be used whenever the principal purpose of the instrument is the acquisition, by purchase, lease, or barter, of property or services for the direct benefit of the government; or whenever an executive agency determines that the use of a contract is appropriate.
- A *grant* is to be used whenever the purpose of the relationship is to transfer money, property, services, or anything of value to accomplish a public purpose of support or stimulation authorized by Federal statute and no substantial involvement is anticipated between the executive agency and the recipient during the performance of the contemplated activity.
- A *cooperative agreement* is to be used whenever the purpose of the relationship is the transfer of money, property, services, or anything of value to accomplish a public purpose of support or stimulation authorized by Federal statute and substantial involvement is anticipated between the executive agency and the recipient during performance of the contemplated activity.

Since the cooperative agreement generally closely parallels grants and contracts, Federal entities often opt to use the government's standard contract format and the applicable general contract conditions, modified to the circumstances. However, the accounting for a cooperative agreement is more similar to that performed for grant agreements.

### **Audits of Federal Grants**

A distinction is generally made to distinguish between audits of a Federal Agency's grants management functions and audits of individual grantees. Audits of an agency's grants management functions (i.e., internal audits) could entail examination of the policies, procedures, and practices by which an agency initiates grants program outreach and generates public awareness for a new or existing grant program, and negotiates, awards, manages, monitors, finances, accounts, and ultimately closes out or settles the Federal grants. Periodic audits of an agency's grants management functions are made by the agency's IGs or its internal audit staff. However, such reviews and examinations could also be outsourced to independent consulting and independent accounting firms.

Exhibit 15.2 is a partial listing of the many factors to consider when planning an audit of a Federal grantee or grant. Specific conditions and circumstances related to individual Federal grants will dictate that alternative sequences testing should be considered or that additional testing should be made. To the extent the listed or other tasks are deemed appropriate but circumstances do not permit performance of those tests, the auditor must reflect this fact in the audit opinion.

### **Audits of Agency Management**

An agency's grants management process may be subjected to periodic internal audits to determine whether program managers are awarding and managing grants in the manner required by Federal law, OMB regulations, and the agency's own grants policies and procedures.

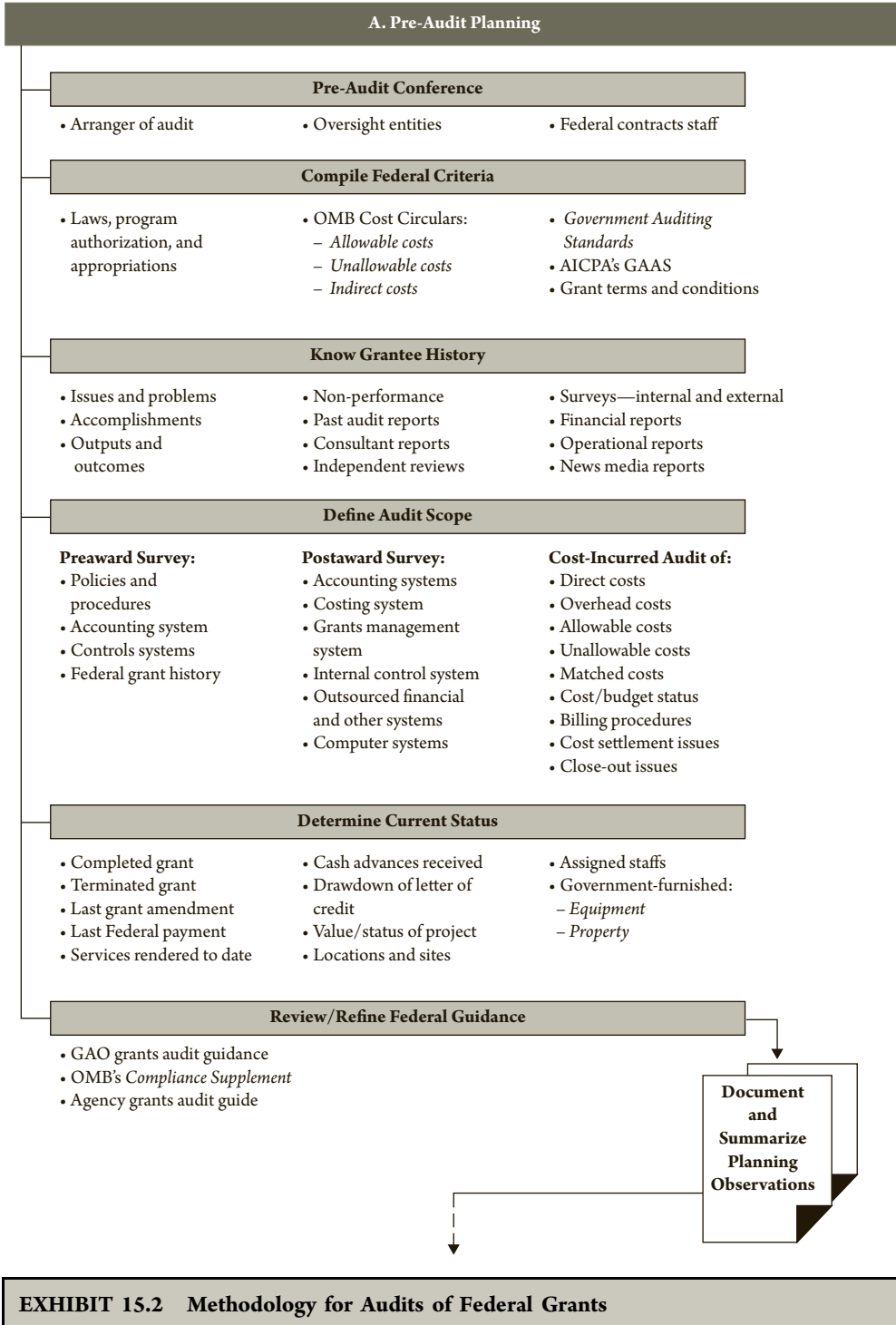
No uniform scope exists for the internal audit of a Federal Agency's grants management functions. Each must be tailored to the program to be audited, and, in this sense, an internal audit is somewhat similar to a performance audit. An audit of an agency's grants management functions can be broad and all-encompassing, blending aspects of a compliance audit, financial-related audit, and a performance audit. Or the audit scope could be limited, concentrating on a single subject or area of the grants function.

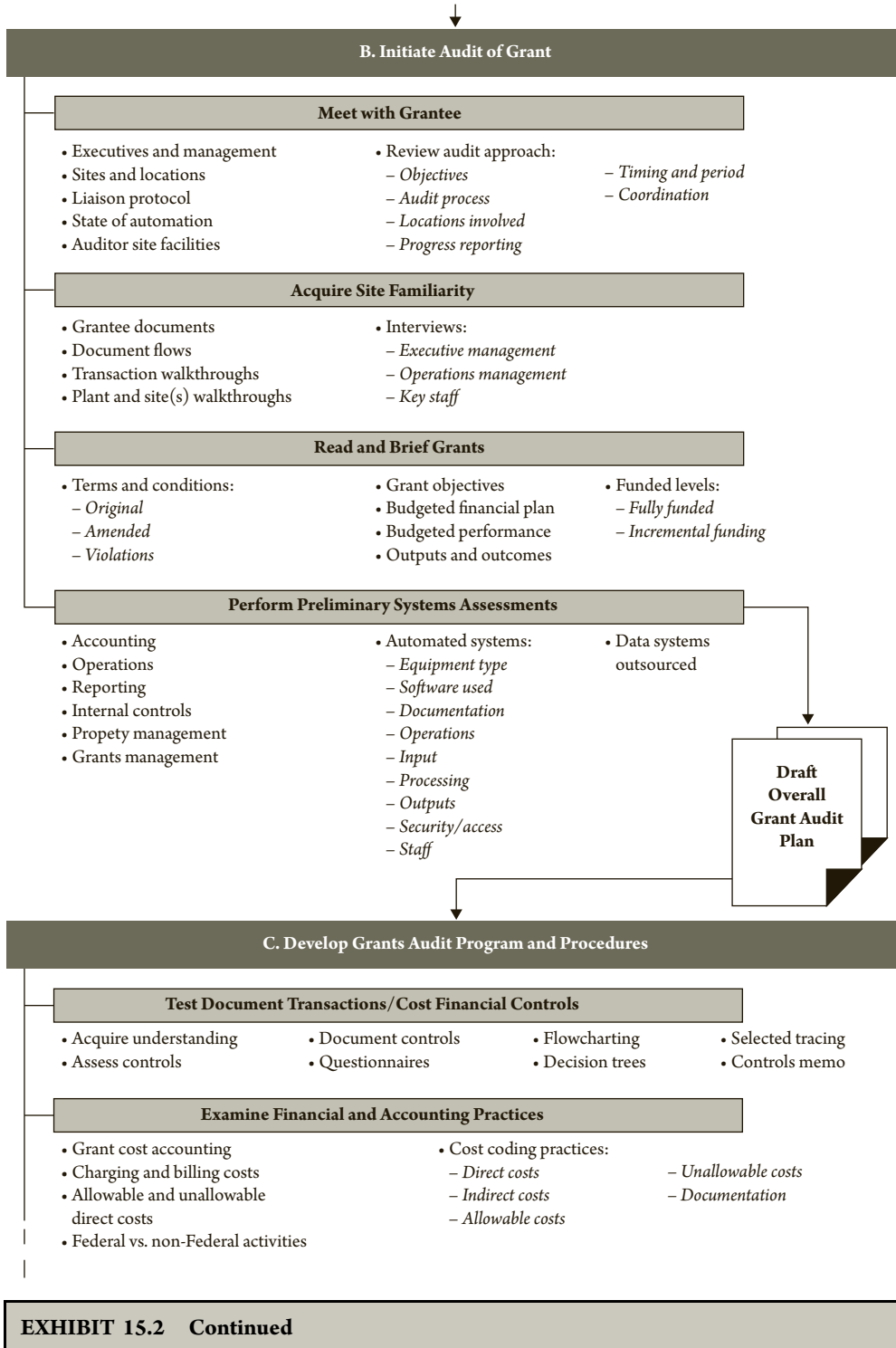
Most likely, the audit will concentrate on one or a few issues concerning the agency's grants management functions, possibly including tests of one or more of these activities that require the auditor to:

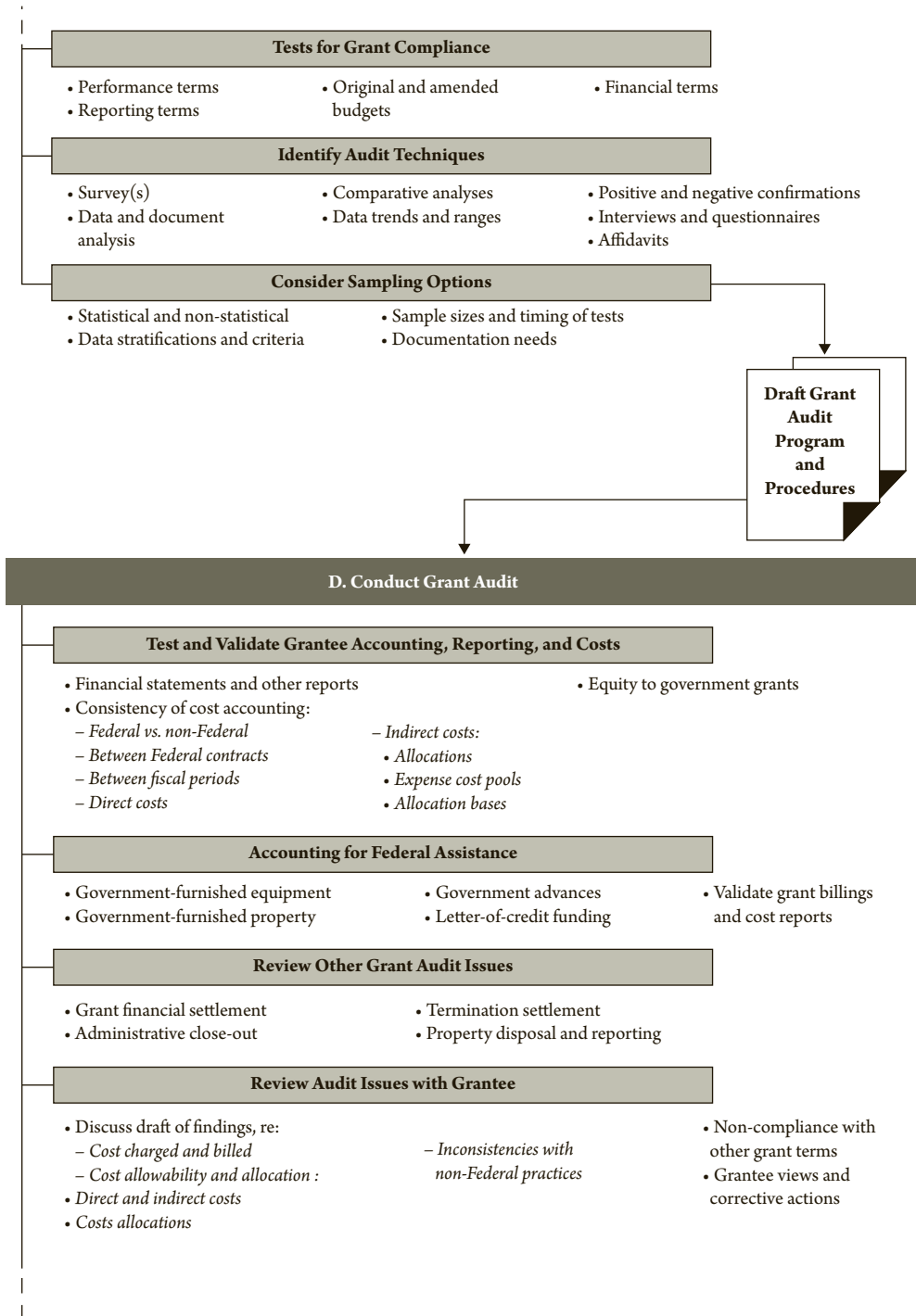
- Assess the decisions reached in determining if the designed grant program is the one intended by the authorization and appropriations acts of Congress.
- Assess the manner and thoroughness with which lists of prospective grantees are compiled, vetted, solicited, and, after grants award, monitored.
- Assess the relative completeness of grant applications, where such is required by, or implicit in, the grants program authorization law.
- Review the grants administration activities, including tasks to monitor grantee performance, grantee progress reports, grantee payments, controls over GFPs, and end-of-grant close-out and settlement practices.

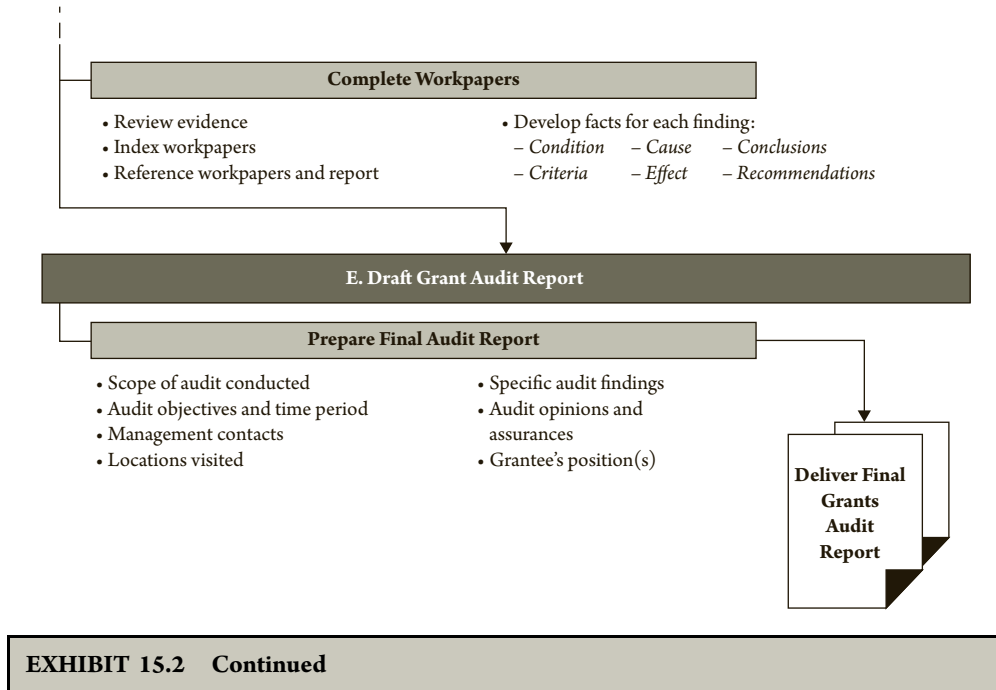
An internal audit of a grants management activity could appropriately be focused on nonfinancial or grants administrative or program management issues. Still another internal audit could, with merit, be an examination of the grant awarding, administration, financial, and monitoring processes. The dollar significance of GFE or GFP in a grantee's possession could also warrant an audit of the manner in which GFE and GPE provided to a grantee was procured, acquired, stored, controlled, and transferred to grantees and used for only authorized purposes. An internal audit typically is made at the grants management program office of the agency, but field and site visits are not uncommon to verify or confirm the











existence of conditions possibly involving grantee's budgets, performance, or financial activities.

## AUDITS OF GRANTEES

Audits and reviews executed in connection with Federal grants generally encompass the activities discussed throughout the next sections.

Although grant audits are largely made by agency Federal IGs and internal audit staffs, many of these audits are also performed by independent accounting firms under contract to Federal and other governmental agencies.

Audits could be, and are, made of a grantee as an entity, but considerably more audits are made of individual grants, particularly those of dollar significance, with program performance scheduled over multiple years. The reasons for grantee and grant audits vary but often include:

- Assessment of costs incurred and billed by a grantee to the Federal grantor to ensure that the grantee is reimbursed for only its actual allowable and relevant costs, to identify and restrain incurrence and billing for exorbitant amounts.
- Review of the quality of a grantee's administrative and property management practices, particularly if the grantee is in possession of significant amounts of GFE and GFP.

- Evaluations of the relative efficiency and effectiveness with which the grantee is managing and administering the Federal grants-in-aid program.
- Tests for compliance with Federal laws, OMB regulations, and agency guidance and rules applicable to the grants program.

### **Types of Grant Audits**

Grant audits may be detailed, transactional-type financial audits of costs incurred and charged to a Federal grant. At times, the term grants audit might more broadly include preaward surveys, postaward surveys, and audits of costs.

#### ***Preaward Surveys***

Should a Federal Agency have limited experience with a prospective grantee who is otherwise deemed responsive and responsible, its auditors might make a preaward survey to generally assess the prospective grantee's systems of financial accounting, cost accounting, internal controls, and project/contract management policies and procedures. Inquiries could also be made of the experiences of other Federal Agencies in relation to the prospective grantee.

#### ***Postaward Surveys***

A postaward survey, if one is conducted, would occur within 90 days of grant award to ensure that a new grantee has in place adequate financial, administrative, and operational policies and procedures and that desirable management practices are being employed for the contract.

#### ***Audits of Direct, Other Costs***

Cost audits of grants are generally made at the conclusion of shorter-term grants but are made periodically of significant grants requiring performance over multiple years. These audits could be a blending of tests to assess the compliance with grants terms and conditions, performance achievement, and financial management. The objectives of a grant audit are dependent on the nature of the grantee, type, and conditions of the specific grant and issues or problems encountered by or with the grantee, but audits often include tests of:

- Costs incurred, charged to, and later billed to the Federal grant.
- Support documents and other evidence of compliance with performance goals and objectives and with the financial terms and conditions of the grant.
- Reasonableness of costs claimed in relation to the expired grant period and desired or expected grant inputs, outputs, and outcomes.
- Appropriateness of cost accounting and cost allocations applied to the Federal grants in comparison to those employed for a grantee's non-Federal activities.
- Proposed costs in comparison to incurred costs to assess the overall efficacy of charges ultimately being paid by the Federal Agency.

### Grant Audit Policies

OMB's *Compliance Audit Supplement* provides guidance for audits of Federal grants and cooperative agreements. Prior to issuance of the *Supplement*, auditors of Federal grants were required to search countless sections of the CFR, OMB circulars, and the grantor agency's own grants policies and procedures in an effort to distill the Federal Government's concerns into a grants audit program. The OMB *Supplement* is an excellent single source for identifying Federal grant audit policies and procedures. With respect to audits of Federal grants, OMB states that application of the *Supplement* will constitute a "safe harbor" for auditors with respect to the nature (i.e., what to audit) of audit procedures to apply. However, and reasonably so, the timing (which months, periods, or accounts to test) and the extent (i.e., how much will be tested) depend on the auditor's judgments and on the circumstances unique to the grantee or grant undergoing audit.

### Audit Issues

This section of the chapter is directed toward audits of Federal grantees and individual grants awarded to non-Federal grantees that could include state and local governments, academic institutions, and some utilities and authorities, plus tens of thousands of not-for-profit organizations.

**Allowable, Unallowable, Indirect Costs.** Within the Federal Government, uniform policy exists defining what the Government has determined to be *allowable*, *unallowable*, and appropriate *indirect costs* that impact the audits of every Federal grant. While this guidance is described in detail in various OMB circulars, the same restrictions appear in laws and various sections of the CFR and in OMB's *Supplement*:

- OMB A-21, *Cost Principles for Educational Institutions*, relocated to 2 CFR Part 220
- OMB A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, relocated to 2 CFR Part 225
- OMB A-122, *Cost Principles for Non-Profit Organizations*, relocated to 2 CFR Part 230
- 48 CFR Part 31, *Contract Cost Principles and Procedures*

These circulars identify selected cost items, define those allowable and unallowable costs appropriate as charges to Federal programs, and describe standard methodologies for calculating and allocating the indirect costs appropriate for use by non-Federal grantees. These cost policies, in practice, are limitations on amounts that may be reimbursed or recovered under any Federal grant. The cost policies articulated in each of these circulars are substantially similar, but some differences do exist, due mainly to the nature of the recipient organization, the nature of programs administered, and the breadth of services and operations of some grantees but not others.

Several policy statements (laws, regulations, OMB circulars, agency rules) detail categories of costs that are absolutely necessary to operate the non-Federal grantee but that are considered unallowable as a matter of declared Federal policy. Some examples of costs declared as unallowable are listed next.

- *GAAP cost accounting*: A general policy of the Federal Government relating to charges, reimbursements, billings, or payments to non-Federal grantees is that costs must:

be determined in accordance with generally accepted accounting principles, except as otherwise provided for in OMB Cost Circulars.

The emphasis on the word *except* is particularly significant to auditors of Federal grant programs because there are many significant exceptions to a grantee being paid when following GAAP.

The characterization of costs by the Federal Government as allowable or unallowable *does not* imply that such costs are unnecessary, unreasonable, or illegal. The term *unallowable* only means that the Federal Government prefers not to pay a grantee for these costs. In most instances, a grantee could not function without the activities supported by many of these so-called unallowable costs. For example, in the case of a government grantee, 2 CFR Part 225, OMB Circular A-87 declares that general costs of a government (e.g., cost of governors, mayors, legislative overseers, and other essential governmental expenses) are unallowable charges to Federal programs.

- *Costs unallowed per public policy*: Unallowed costs per public policy include write-off of uncollectible receivables; accrued costs for contingent liabilities; state and local government taxes; advertising costs; costs of idle facilities; lobbying costs; financing costs; donations; and contributions. The accounting and reporting of these costs are mandated and appropriate under GAAP but are classified as unallowable by the Federal Government for charges to Federal grants.
- *Costs unallowed unless "funded"*: All pension costs of grantee employees; postretirement health and other benefit costs due to government employees; and self-insured liabilities and costs are deemed unallowable until actually funded. The accounting and reporting of these incurred but not paid costs are required by and appropriate under GAAP but are classified as unallowable by the Federal Government as charges to Federal grants.
- *Cost unallowed unless approved in advance*: cash drawdown in excess of three days; employee relocation costs; recruiting costs; subscriptions costs; professional membership fees; and purchase of capital assets. The accounting and reporting of these costs are mandated and appropriate under GAAP but are classified as unallowable by the Federal Government as charges to Federal grants, unless advance approval was obtained.

Unallowable costs may not be charged to, claimed under, or billed directly or indirectly to any other contract, grant, or program of Federal assistance. If so done, such costs would be an audit finding reportable as a *questioned cost* by the auditor.

### Allowable Costs Criteria

The audit tests to meet Federal procurement policy and allowable cost criteria require the auditor to determine allowability by testing direct and indirect costs charged to, or claimed under, a Federal grant and verify that the cost elements meet each of several defined factors of allowability. To be allowable under Federal grants costing criteria, all direct and indirect costs charged or claimed by a contractor must meet each of these ten criteria:

1. Be *necessary and reasonable* for the proper and efficient performance and administration of Federal awards.

*Necessary costs* are costs required, implicitly or explicitly, by law, regulations, and the Federal contract agreement to support the program outlined in the Federal contract. Necessary cost criteria should be assessed from the view of the purpose, timing, amount, authorization and approval, and the ultimate accounting of charged costs in relation to the performance period of the contract.

*Reasonable costs* are costs that are reasonable if, in nature and amount, they do not exceed that which would be incurred by a prudent person under circumstances prevailing at the time the decision was made to incur the cost. Determination as to the reasonableness of costs must give consideration to the following questions:

- Do the claimed costs exceed the type generally recognized as ordinary and necessary for the operation of the contractor or attainment of the performance or objectives outlined in the executed Federal contract?
  - Do the claimed costs exceed restraints on spending or cost requirements imposed by sound business practices, presence of arm's-length bargaining, terms of Federal and other laws, regulations, and terms, or as conditions of the Federal contract?
  - Do the claimed costs exceed market prices for comparable goods or services?
  - Do the claimed costs significantly deviate from established practices in a manner that unjustifiably increases the cost to the Federal contract?
2. Be *allocable* to Federal awards under the provisions of FAR cost principles.

*Allocable costs* are costs that are allocable if the cost is directly allocable to a particular cost objective or if the goods and services involved are chargeable or assignable to such cost objectives in accordance with relative benefits received. OMB requires that determination of *allocability* of costs give consideration to:

- All activities that benefit from a unit's indirect cost, including unallowable activities and services donated by third parties, receive an appropriate allocation of indirect costs.



- Unless otherwise permitted in writing, any cost allocable to a particular Federal contract or cost objective may not be charged to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by law or terms of Federal awards, or for other reasons.
  - Where an accumulation of indirect costs will ultimately result in charges to a Federal contract, a cost allocation plan will be required, similar to those outlined in CASB standards or the appropriate OMB cost circulars.
3. Be *authorized* and *not otherwise prohibited* under any Federal, state, or local laws or regulations.
  4. *Comply* with any limitations or exclusions set forth in the FAR, cost principles in OMB circulars, terms and conditions unique to the Federal contract, or other governing regulations regarding types, amounts, or limits on cost items.
  5. Be in *conformance with policies, regulations, and procedures* that apply uniformly to both Federal and non-Federal contracts and awards and to Federal and non-Federal activities of the non-Federal entity receiving assistance under a Federal contract.
  6. Be accorded consistent cost accounting treatment.

*Consistent cost accounting treatment* means that costs may not be assigned to a Federal award as a direct or indirect cost if any other cost has been incurred for the same purpose, in like circumstances, and has been allocated to the Federal award directly or, in part, indirectly. The consistency requirement relates to the uniform accounting and charging of costs to both Federal and non-Federal activities of a contractor between fiscal reporting periods.

7. Be determined in accordance with GAAP, *except* as otherwise provided for in OMB cost circulars.
8. Be *not* included as a cost or used to meet *cost sharing or matching* requirements of any other Federal award in either the current or prior period, except as specifically provided by Federal law or regulation. This restriction prohibits a contractor from claiming direct or indirect costs that were charged to the Federal Government under one Federal agreement to meet a cost-sharing or cost-matching cost requirement of another Federal agreement.
9. Be net of all applicable credits.

*Net of applicable credits* refers to receipts or the reduction of expenditure-type transactions that offset or reduce expense of items charged to Federal contracts as direct or indirect costs (e.g., purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebate, or other price adjustments). In applying costs net of applicable credits, the allocability of net costs must give consideration to:

- The extent that such credits relate to allowable costs, the credits must be applied to the Federal award as a cost reduction or cash refund, as appropriate.

- Amounts of any credits should be recognized in determining indirect cost rates or amounts to be charged to Federal awards.

10. Be adequately *documented*.

Audits of direct and indirect costs and matching contributions claimed or charged must be tested to support documentation that identifies or relates to the amount, timing, and purpose of transactions to the specific Federal contract. For example, the timing of the transaction must be within the contract period. In most instances, transactions preceding or following grant award are not allowable in the absence of specific approval by the Federal Agency.

Supportive documentation, as defined in literature of GAO and the AICPA, includes:

- *Accounting records of original entry*. Examples include journals, registers, ledgers, manuals, worksheets, and support for cost allocations. Alone, though, these types of accounting data are not sufficient supporting documentation.
- *Corroborating evidence*. Examples include canceled checks, invoices, contracts, grants, minutes of meetings, confirmations, and other written statements by knowledgeable personnel, information obtained by auditor inquiry, observation, inspection, personal examination, and other information developed by, or available to, the auditor.
- *Independent tests* must be made by the auditor of underlying data and records and include analyses, reviews, retracing procedural steps of the financial process, auditor recalculations, and performance of reconciliations of any cost allocations.

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The auditor must make *independent* tests of underlying data and records and include analyses, reviews, retracing procedural steps of the financial process, auditor recalculations,

and performance of reconciliations of any cost allocations. In audits of Federal grants, claims, or charges to the grant that are not sufficiently documented or supported, or if the auditor is unable to satisfy him- or herself by other evidential means as to the propriety and allowability of costs, such amounts must be “questioned” and reported to the Federal Agency for resolution.

### **Tests of Federal Grant Compliance Policies and Regulations**

The *Supplement* identifies ten procurement compliance regulations, noncompliance with which could have a direct and material effect on the accounting, charging, and billings to Federal grants. If the grant is materially significant to the grantee, noncompliance under a Federal grant might well affect the overall financial statements of the grantee.

The OMB *Supplement* identifies ten procurement compliance regulations, noncompliance with which could have a direct and material effect on the accounting, charging, and billings to Federal contracts. If the contract is materially significant to the contractor, noncompliance under a Federal contract might well affect the contractor’s overall financial statements. The compliance policies associated with individual contracts and of importance to contract audits are listed next.

1. *Costs charged to government: allowable, unallowable, direct, and indirect costs.* Dating to the middle of the last century, it has been Federal Government policy that the government will permit only certain direct and indirect costs to be claimed by and reimbursed under Federal contracts. Federal money may not be claimed or paid for any direct or indirect costs defined as unallowable by Federal policy. OMB has provided these definitions of direct and indirect costs:
  - *Direct costs* are those that can be identified specifically with a particular final cost objective. Typical direct costs chargeable to Federal contracts include employee compensation, cost of materials, equipment if specifically approved, and travel expenses subject to Federal limits.
  - *Indirect costs* are those (a) incurred for a common or joint purpose benefiting more than one cost objective and (b) not readily assignable to the cost objectives specifically benefited, without an effort that is disproportionate to the results achieved. To facilitate equitable distribution of indirect expenses to the cost objectives served, it may be necessary to establish a number of pools of indirect costs within the contractor. Indirect cost pools should be distributed to benefited cost objectives on bases that will produce an equitable result in consideration of relative benefits derived. Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality, where such accounting treatment for that item of cost is consistently applied to all cost objectives.

2. *Equipment, real property.* The title to equipment acquired by non-Federal entities with Federal monies could remain with the non-Federal entity or with the Federal Government. Here, *equipment* is defined as tangible, nonexpendable property with a useful life of more than one year and an acquisition cost of \$5,000 or more per unit.
3. *Matching contributions.* Matching requirements, in kind or other, often require examination of the terms and conditions of the individual contract. Matching requirements are often specific as to the *amount, type, timing, and purpose* of match that is permissible. For example, if the agreed-upon match is to be cash, donated labor, or any other type of contribution, free or paid, it would be unallowable. Also, there may be a requirement that the match be provided within a certain time period; compliance in a later period would have to be reported.
4. *Availability of program funds.* Legislation for all Federal appropriations and other financial assistance places limits on the *amount* of funds being provided, the purpose for which the funds are provided, and a *time* period (or use period) after which the authority to spend the Federal monies lapses. (OMB Circular A-102, the “common rule,” should be consulted for additional guidance on this compliance requirement.)
5. *Procurement, suspension, debarment.* Presidential executive orders and Federal regulations prohibit Federal Agencies from contracting with or subcontracting to parties that have been suspended or debarred or whose principals are suspended or debarred.
6. *Program income.* *Program income* is the gross income directly generated by the Federal project during the contract period (e.g., fees earned for services, rental income, sale of commodities or items fabricated under the program, payment of principal, and interest on loans made from Federal funds). Unless otherwise specified by the Federal Agency, program income shall be deducted from program outlays.
7. *Reporting.* Recipients of Federal contracts must use prescribed standard forms for financial, performance, and special reporting. Auditors must confirm that controls have been implemented to ensure that reports, claims for advances, and reimbursements are supported by the same books and records from which the entity’s financial statements were prepared. Tests must be made to ensure submitted reports, claims for advances, and reimbursements are supported by underlying documentation and appropriate corroborating evidence.
8. *Special tests and provisions.* Laws, regulations, provisions of contracts, and grants contain requirements for special tests. The auditor must review the specific terms and conditions of the contract since the contract could contain conditions warranting special examination. The axiom of the legal profession applies equally to contract audits: *When all else fails, read the contract.* There is no substitute for examining the terms and conditions of specific contracts, bond covenants, terms

of loans, loan guarantees, and so on under which money or financial assistance is provided to support contracts to non-Federal entities.

9. *Activities: allowable, unallowable.* Public monies may be used only for those activities allowed by law or regulation. Congress determines that certain organizations, groups, or individuals are to be beneficiaries of funding provided under particular Federal legislation. The law will also define the qualifying conditions and the benefits to be conferred. Permitted and prohibited activities must be identified, and audit tests made, to ensure that Federal monies are used to support only those activities permitted by law or regulation. Audit tests must be made to ensure that Federal monies were used to support only those activities permitted law or regulation.
10. *Cash management: advance funding of government programs.* For some contractors, forms of advance funding exist (e.g., lump-sum or total advance of required Federal funding; advances made at designated points during the contract period; or periodic drawdowns under a prearranged letter-of-credits procedure arranged between the contractor, the U.S. Treasury, and a local commercial bank). Under the Cash Management Act, a contractor's procedures for drawing down Federal funds must minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by the contractor. Historically, the cash balance could not be in excess of three business days.

When deciding whether to test a compliance requirement, the auditor must conclude whether (1) the requirement does or does not apply to the contract and (2) noncompliance with the requirement could or could not have a material effect on the contract. An audit report of a Federal grantee or for an individual grant may, in addition to an audit opinion, be presented in narrative form and supported by exhibits, tables, graphs, and illustrations that, in the auditor's judgment, are necessary to make a full reporting of the facts relative to the audited grant(s).

### **AMERICAN RECOVERY AND REINVESTMENT ACT**

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On February 13, 2009, Congress passed the American Recovery and Reinvestment Act (Recovery Act) of 2009. A direct response to the economic crisis, the Recovery Act has three immediate goals:

1. Create new jobs and save existing ones.
2. Spur economic activity and invest in long-term growth.
3. Foster unprecedented levels of accountability and transparency in government spending.

For transparency purposes, the Recovery Act requires recipients of recovery funds to report every January, April, July, and October on how these funds are being utilized. The

required information is posted on [www.Recovery.gov](http://www.Recovery.gov) for public access and monitoring purposes.

The Recovery Act imposes unique transparency requirements that modify the standard practices for presolicitation and award notice process. Modifications were recorded on the FAR to correspond to Recovery Act requirements. According to the requirements, a Government Agency must provide: (1) a rationale for using other than fixed-price or competitive approaches in award notices, (2) a description of supplies and services that is clear and unambiguous to support public transparency and understanding of the procurement; and (3) special posting requirements for modifications as well as orders under task and delivery order contracts.

The Recovery Act recommends agencies to structure grants to result in meaningful and measurable outcomes that are consistent with agency plans and that promote the goals of the Recovery Act. The evaluation criteria for award should include those that bear on the measurement and likelihood of achieving these outcomes, such as jobs creation and preservation.

Recovery Act funds that are used for grants may potentially be used for existing grants through a continuation of a grant or a renewal grant. However, since Recovery Act funds must be monitored and accounted for separately, supplements to existing agreements are not recommended, as there is a greater risk that the grantee will be unable to monitor and report Recovery Act funds separately.

Agencies must take steps, beyond standard practice, to initiate additional oversight mechanisms in order to mitigate the unique implementation risks of the Recovery Act. At a minimum, agencies should be prepared to evaluate and demonstrate the effectiveness of standard monitoring and oversight practices associated with performance management and accountability as well as internal controls assessment.

Agencies are required to utilize standard award terms and conditions on award notices, unless a conflict exists with the requirements of the Recovery Act. In such cases, the agency's award term or condition should be modified as necessary to ensure compliance with the Recovery Act. Any funding provided through the Recovery Act is required to make clear through notice or documentation that it is *one-time* funding. Agencies must include the requirement that each grantee or subgrantee awarded Recovery Act funds shall promptly refer to an appropriate IG any credible evidence that a principal, employee, agent, contractor, subgrantee, subcontractor, or other person has submitted a false claim under the False Claims Act or has committed a criminal or civil violation of laws pertaining to fraud, conflict of interest, bribery, gratuity, or similar misconduct involving those funds.

In relation to contract award planning under the Recovery Act, agencies must take into consideration specific actions related to acquisition planning. Such actions include:

- Contract type selection.
- Competition.
- Acquisition objectives and award evaluation criteria.

- Existing contracts.
- Interagency agreements.
- Small business participation.
- Environmental and safety.
- Contract financing and contract deliverable structure.

Based on the high risk associated with the award and expenditure of Recovery Act program funds, there has been increased oversight by the agencies. In addition, the Recovery Accountability and Transparency Board, established by the Recovery Act, Congress, and OMB, oversees and monitors implementation of the Recovery Act through periodic reporting on the use and expenditure of funds. The effectiveness of monitoring and oversight is based on various areas, including:

- Progress against program schedule and performance objectives.
- Qualification and number of acquisition, grants, and program management staff.
- Use of competition.
- Timeliness of awards.
- Dollars obligated and expended.

Section 1512 of the Recovery Act requires reports on the use of Recovery Act funding by recipients no later than the tenth day after the end of each calendar quarter (beginning in the quarter ending September 30, 2009) and for the Federal Agency providing those funds to make the reports publicly available no later than the thirtieth day after the end of that quarter. Prime recipients of all programs identified in the list of Federal programs subject to Section 1512 of the Recovery Act are responsible for reporting the information required by Section 1512 of the Recovery Act. Aimed at providing transparency into the use of these funds, the recipient reports must include this detailed information:

- Total amount of funds received; and of that, the amount spent on projects and activities
- A list of those projects and activities funded by name to include:
  - Description
  - Completion status
  - Estimates on jobs created or retained
- Details on subawards and other payments

The prime recipient is ultimately responsible for the reporting of all data required by Section 1512 of the Recovery Act. and this guidance includes the Federal Funding Accountability and Transparency Act (FFATA) data elements for the subrecipients of the prime recipient required under Section 1512(c)(4). Prime recipients may delegate certain reporting requirements to a subrecipient (i.e., FFATA data). However, if the reporting is delegated to a subrecipient, the delegation must be made in time for the subrecipient to prepare for the reporting, including registering in the system.

The Recovery Act requires the submission of reports related to estimates on jobs created or retained. Two types of job reports are required by the Recovery Act: (1) Quarterly reports that detail the impact of programs funded through Recovery funds on employment, economic growth, and other key indicators are required to be submitted to Congress. The quarterly reports are generated by Federal Agencies through the assistance of OMB and the Council of Economic Advisers (CEA). (2) Non-Federal recipients who receive funding through discretionary appropriations must submit job estimate reports in terms of conditions of contract, grant, and loan agreements. Job estimate reports should be submitted according to Section 1512(c)3(D) of the Recovery Act.

Section 1605 of the Recovery Act requires that projects for the construction, alteration, maintenance, or repair of a public building or public work use American iron, steel, and manufactured goods in the project unless a specified exemption applies.

Chapter 7 of the Yellow Book provides guidance for the desired narrative-type audit reports and should be consulted before undertaking an audit of Federal grants. Further, the guidance in Chapter 7 is part of the criteria used by Federal IGs and GAO in assessing the adequacy of the grants audits.



# 16 ATTESTATION REPORTS

Sound financial management in the Federal Government requires a wide assortment of special reports that enable Federal executives and managers to effectively exercise their oversight responsibility and guide and control programs for which they are responsible.

Some of these special reports (performance audits and grant audits) were discussed in prior chapters. This chapter presents additional reports that are commonly utilized by Federal Agencies.

## ATTEST ENGAGEMENTS

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The reports and engagements discussed in this chapter are referred to as *attest engagements*. The American Institute of Certified Public Accountants (AICPA)'s Statements on Standards for Attestation Engagements (SSAEs) currently in effect are listed next.

- SSAE 10, *Attestation Standards (ATs): Revision and Recodification* (Attestation Standards (ATs) 101–401, AT 601, AT 701)
- SSAE 11, *Attest Documentation* (AT 101.100–101.108, AT 201.27–AT 201.30, AT 301.17, AT 301.32)
- SSAE 12, *Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification* (AT 101.17, AT 101.18)
- SSAE 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AT 20)
- SSAE 14, *SSAE Hierarchy* (AT 50)
- SSAE 15, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated with an Audit of Its Financial Statements* (AT 501)
- SSAE 16, *Reporting on Controls at a Service Organization* (AT 801)
- SSAE 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence Is Impaired* (AT 301.23)

For government engagements, the guidance also includes Chapter 5 (“Standards for Attestation Engagements”) of the *Government Auditing Standards* (2011 revision, Yellow Book) of the Government Accountability Office (GAO).

### **Attestation Standards**

As is the case with financial audit engagements, attestation engagements are to be executed in accordance with certain basic standards developed by the AICPA. These standards, which are similar but not identical to the audit standards, are set forth in AT 50 and are summarized next.

#### ***General Standards***

1. The engagement shall be performed by a practitioner having adequate technical training and proficiency to perform the attestation engagement.
2. The practitioner must have adequate knowledge of the subject matter.
3. The practitioner must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.
4. The practitioner must maintain independence in mental attitude in all matters related to the engagement.
5. The practitioner must exercise due professional care in the planning and performance of the engagement and the preparation of the report.

#### ***Standards of Fieldwork***

1. The practitioner must adequately plan the work and must properly supervise any assistants.
2. The practitioner must obtain sufficient evidence to provide a reasonable basis for the conclusion that is expressed in the report.

#### ***Standards of Reporting***

1. The practitioner must identify the subject matter or assertion being reported on, and state the character of the engagement in the report.
2. The report shall state the practitioner's conclusion about the subject matter or the assertion in relation to the criteria against which the subject matter was measured.
3. The practitioner must state all of the practitioner's significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto in the report.
4. The practitioner must state in the report the report is intended solely for the information and use of the specified parties under the following circumstances:
  - When the criteria used to evaluate the subject matter are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria.
  - When the criteria used to evaluate the subject matter are available only to specified parties.

- When reporting on subject matter and a written assertion has not been provided by the responsible party.
- When the report is on an attestation engagement to apply agreed-upon procedures (AUPs) to the subject matter.

### **Additional Government Standards in the Execution of Attestation Engagements**

As noted earlier, Chapter 5 of the Yellow Book adds additional standards. These standards are summarized next.

#### ***Additional Fieldwork Standards***

- Communicate to management and relevant oversight organizations, including legislative committees, when there are appropriate findings that in the auditor's judgment are significant and pertinent to the organization contracting the auditor's services. (Sections 5.04–5.05)
- Consider previous audits and attestation engagements, and determine whether recommendations were followed by appropriate follow-up corrective action. Consider whether testing the effectiveness of compliance with recommended corrective action is warranted. (Section 5.06)
- Incorporate fraud and abuse detection procedures in the testing, including testing for noncompliance with laws and regulations and, when applicable, compliance with Federal contract and grants agreements. (Sections 5.07–5.10)
- Ensure that the documentation and, when applicable, the report of findings clearly identify these elements of the finding: criteria, condition, cause, and effect. (Sections 5.11–5.15)
- Ensure that expanded documentation requirements, including the adoption of the “experienced auditor” standard, documentation of supervisory review, documenting departures from generally accepted government auditing standards (GAGAS), and making audit documentation and auditors involved in the execution of the engagement are available to appropriate reviewers and other auditors. (Sections 5.16–5.17)

#### ***Additional Reporting Standards***

- Disclose in the report that the examination was conducted in compliance with GAGAS. (Section 5.19)
- Report significant deficiencies and material weaknesses in internal controls; instances of fraud; events of noncompliance with laws, regulations, and contracts; and abuses that affect the assertion. (Sections 5.20–5.26)
- Report all findings to management and include management responses in the report. When appropriate, report findings to other stakeholders, such as those

charged with governance (e.g., in cases of significant noncompliance with laws and regulations, fraud, etc.). (Sections 5.29–5.38)

- When pertinent information cannot be publicly disclosed (e.g., classified information), disclose that certain information has been omitted as well as the reasons for doing so. (Sections 5.39–5.43)
- Ensure that rules are followed in the distribution of reports. (Section 5.44)

The attestation engagements discussed in this chapter must comply with the standards discussed in this section.

### **Reports on Management's Assertions**

Reports on management's assertions typically address compliance with specific requirements that an entity is required to meet. Compliance with requirements may take numerous forms, including compliance with laws and regulations, contractual covenants, specific entity policies, and so on.

Within the Federal Government, a common use of these types of reports concerns the execution of an agency's oversight function. Such reports can be very useful in evaluating Federal grantees and contractors, including entities participating in major Federal programs such as Medicare and Medicaid.

A report on management's assertion is always interchangeable with a report on a subject matter. This is true because the assertion itself addresses compliance with a subject matter. The auditor always has the option (assuming the client concurs) to report on compliance with a subject matter instead of the assertion. The discussion in this chapter applies equally to reports on compliance with a subject matter; the only difference is the wording included in the clean opinion example. In this instance, the auditor reports on the subject matter directly in the introductory and opinion paragraphs.

In many respects, the approach to the execution of this engagement parallels the execution of financial audits. As with financial statement audits, the effort normally consists of a planning phase, an internal control evaluation phase, a testing phase, and a reporting phase. The difference, of course, lies in what happens during the execution of each phase.

### ***Determining the Feasibility of the Engagement***

At the outset, the auditor must determine whether it is possible to evaluate compliance at all (General Standard No. 3). In fairness, this possibility must be considered before the auditor is engaged to execute the project. In practice, this determination may not be feasible until additional information becomes available during the planning phase. Very seldom is establishing the feasibility of the project straightforward; generally it requires the exercise of judgment.

Thus, besides providing for an effective audit approach governing the execution of latter phases, a successful engagement approach must consider the next questions/issues:

- *Can we do it?*

There are no fast rules to guide the auditor's decision regarding the feasibility of this type of engagement. The decision often is a subjective one. Basic requirements in support of this decision must include a well-defined yardstick (e.g., clear rules and regulations) against which performance activities can be measured and the presence of audit trails that document support whether the requirements (e.g., rules and regulations) were complied with during the performance of the relevant activities.

- *How can we tell right from wrong?*

Having established the feasibility of measuring performance, the auditor must consider materiality. If anything, this is more subjective than the previous endeavors. The definition of materiality requires an in-depth understanding of the subject matter, including a consideration of both the letter and the spirit of the requirement. In this respect, it is essential to obtain management views regarding materiality. This is particularly relevant when the auditor is engaged by a government agency to assess compliance by a third party. While the auditor must maintain independence in the definition of materiality, the engagement will be of little use to the client if there is a significant difference of opinion regarding materiality. The ability to determine materiality rests on the answers to the next question.

- *Can we do it or do we need help?*

To establish materiality (e.g., what percentage of noncompliance is unacceptable), it is important that members of the audit team have both experience with the subject matter addressed by management's assertion and related requisite technical skills. It is not unusual for engagements of this nature to require the retention of subject matter experts (SMEs). For example, the execution of this type of engagement in connection with Medicare and Medicaid programs often requires the services of actuaries and medical professionals. However, the presence of an SME does not lessen the requirement for auditors to have the requisite experience with the subject matter being evaluated.

- *We can do it; now what?*

It is essential that the auditor carefully document his or her decision-making process and clearly set forth why in his or her judgment the engagement can be executed. Once the questions posed earlier are answered, the planning phase can be completed.

### ***Internal Controls and Related Testing***

Typically, planning provides for a risk-based approach similar to that used in the execution of financial audits. In this regard, it is important to note that the identification of internal controls and related testing of controls that assist in promoting compliance with the subject matter covered by the assertion is essential to the successful execution of the

engagement. The urge to jump directly into testing without considering risk and internal controls must be avoided.

### **Reporting**

We have included selected opinions as examples of reports on management's assertions. To comply with GAO standards, AT Interpretation 9101.58 suggests auditors consider adding the following additional paragraph:

In accordance with *Government Auditing Standards*, we are required to report significant deficiencies in internal control, identifying those considered to be material weaknesses, violations of provisions of contracts or grant agreements, and abuse that could have a material effect on [subject matter], and any fraud and illegal acts that are more than inconsequential that come to our attention during our examination. We are also required to obtain the views of management on those matters. We performed our examination to express an opinion on whether [subject matter] is presented in accordance with the criteria described above and not for the purpose of expressing an opinion on the internal control over [subject matter] or on compliance and other matters; accordingly, we express no such opinions. The results of our examination did not disclose any matters required to be reported under *Government Auditing Standards* [or: Our examination disclosed certain findings that are required to be reported under *Government Auditing Standards* and those findings, along with the view of management, are described in the attached Schedule of Findings].

We believe this paragraph or similar language should be added/reported whenever Yellow Book standards apply. In the interest of brevity, the examples presented next omit this paragraph.

Exhibit 16.1 presents an example of an unqualified report on management's assertion.

Qualified and adverse opinions require (1) changes to the introductory paragraph, (2) introduction of an explanatory paragraph discussing noncompliance, and (3) an opinion paragraph addressing the subject matter directly and not management's assertion. Exhibit 16.2 is an example of a qualified (or adverse) report on management's assertion.

The preceding introductory and explanatory paragraphs are used for both qualified and adverse opinions. As is the case with the introductory paragraph, qualified and adverse opinions address the subject matter directly, not the assertion. An example of a qualified opinion paragraph appears next.

In our opinion, except for the material misstatement [or deviation from the criteria] described in the preceding paragraph, [subject matter] referred to above, presents, in all material respects, [subject matter] based on [criteria].

<b>EXHIBIT 16.1 Examination Report on Management's Assertion (Unqualified Opinion)</b>
--

***Independent Accountant's Report***

To [Federal Agency]

We have examined management's assertion [identify the assertion]. [Auditee]'s management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertion and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on [identify established or stated criteria].

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

Firm's Signature

DATE

---

<b>EXHIBIT 16.2 Examination Report on Management's Assertion (Qualified or Adverse Opinion)</b>
---

We have examined [subject matter]. [Auditee]'s management is responsible for [subject matter]. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting [subject matter] and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Our examination disclosed the following [describe material misstatement or deviation from criteria].

---

If the noncompliance warrants an adverse opinion, the opinion paragraph should read as follows:

In our opinion because of the material misstatement [or deviation from the criteria] described in the preceding paragraph, [subject matter] referred to above, does not comply with the aforementioned [criteria].

*Disclaimers* require a different introductory paragraph since auditors were unable to issue an opinion:

We were engaged to examine [subject matter]. [Auditee]’s management is responsible for the [subject matter].

Since we were unable to execute the necessary procedures as a result of scope restrictions, there is no scope paragraph. Instead, the report requires an explanatory paragraph setting forth the scope limitations.

Finally, if a disclaimer is issued instead of an opinion we insert a disclaimer paragraph:

Because of the restriction on the scope of our examination discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on [subject matter] referred to above, presents, in all material respects [subject matter] based on [criteria].

### ***Practical Consideration***

Care should be exercised in ensuring that *qualified and adverse opinions address the subject matter* and not the representation by management. It is not unusual for Federal Agencies and even some practitioners to not be aware of or to simply forget about this requirement. Keep in mind that this is a requirement and not an option, as is made clear by AT 601.64 (qualified opinion) and AT 601.66 (adverse opinion). While the guidance uses the term *should*, we see no reason why a practitioner should go out of his or her way to justify a departure (i.e., report on the assertion directly) given the revised guidance included in AU-C 200.25 regarding deviations from “presumptively mandatory requirements” (i.e., when they should be used) and the arguably onerous documentation requirements imposed by AU-C 230.13 when a deviation from the guidance occurs.<sup>1</sup> All departures from a clean opinion are addressed by AT 601.63. However, the guidance for disclaimer reports is not fully covered by AT Section 601. Instead, AT 601.63 refers the reader to AT 101.73 and 101.74 for guidance. This guidance does not indicate whether the report should address the subject matter directly. Thus, it is not clear whether disclaimers should also address the subject matter and not the representation.

Since directly addressing the subject matter is always an option, there is no reason to adopt a position not directly sanctioned by the guidance. Thus, the example provided for disclaimers also addresses the subject matter and not management’s representation.

All of the reports just discussed contain a final paragraph restricting distribution. This restriction is not mandatory unless the auditor determines that the criteria used to evaluate

---

<sup>1</sup> The AICPA is currently engaged in a clarification and recodification effort that will replace the current AUs. The term AU-C refers to section numbers that have replaced AUs. Once this effort is completed (anticipated for 2014), all references will revert back to AU



compliance are available only to the parties involved in the assertion or to a limited number of parties. However, AT 601.62 states that the auditor is free to restrict distribution of the report if he or she so desires. Due to the often complex nature of compliance requirements with Federal regulations, as a practical matter, the auditor generally should restrict distribution of the reports.

### **Reports on Agreed-Upon Procedures**

Arguably, the most distinguishing characteristic of AUPs is the fact that the client/auditee and not the auditor is responsible for identifying and developing the procedures to be performed. However, it is important to note that the auditor is still responsible for ensuring that: (1) the subject matter is capable of being evaluated (General Standard No. 3); (2) the parties involved agree on the sufficiency and relevancy of the procedures; (3) the auditor (with the aid of specialists if necessary) has the expertise to execute the procedures; and (4) the procedures themselves can be objectively stated or defined without requiring a significant amount of judgment during execution and/or evaluation of results. Additional requirements are documented in AT 201, *Agreed-Upon Procedures Engagements*.

In general, the procedures can take one of two forms:

- A client auditee responsible for the subject matter requests that certain procedures be performed.
- A client requests that certain procedures be performed on a third party where the third party is responsible for the subject matter. In these instances, the client typically has the ability to influence the third party in connection with the execution of activities surrounding the subject matter (e.g., the client has enforceable oversight responsibilities over the third party).

Both forms of an Agreed-Upon Procedures Report are common to the Federal Government. The first form is useful to management and other stakeholders of the Federal Agency and the second is useful in carrying out agency oversight and/or regulatory duties.

Exhibit 16.3 is an example of such a report issued by GAO regarding certain Department of Transportation activities.

### ***Practical Consideration***

A very unusual feature of this type of engagement is that the auditor expresses no opinion. Note from the examples the objective nature of this type of report.

This fact is not always apparent to management that engages this service. Disappointment with the professional services provided is always a risk, even if the auditor conducted an efficient and effective engagement and complied with all professional requirements.

The auditor should be aware that it is not unusual for initial procedures developed by the client to require significant judgment on the part of the auditor. Worse, if the client is

**EXHIBIT 16.3 Report on Agreed-Upon Procedures**

November 3, 2011

To: U.S. Department of Transportation

We have performed the procedures described in the enclosure to this letter, which we agreed to perform and with which you concurred, solely to assist your office in ascertaining whether the net excise tax revenue distributed to the Highway Trust Fund (HTF) for the fiscal year ended September 30, 2011, is supported by the underlying records.

We conducted the engagement in accordance with U.S. generally accepted Government auditing standards, which incorporate certain financial audit and attestation standards established by the American Institute of Certified Public Accountants.

You are responsible for the adequacy of these agreed-upon procedures to meet your objectives, and we make no representation in that respect. The procedures we agreed to perform were related to (1) transactions that represent the underlying basis of amounts distributed from the general fund to the HTF during fiscal year 2011, (2) the Internal Revenue Service's (IRS) quarterly HTF excise tax receipt certifications prepared during fiscal year 2011, (3) the U.S. Department of the Treasury's Financial Management Service adjustments to HTF excise tax distributions during fiscal year 2011, (4) the U.S. Department of the Treasury's Office of Tax Analysis's (OTA) estimates of excise tax amounts to be distributed to the HTF for the fourth quarter of fiscal year 2011, (5) adjustments to the HTF for tax on kerosene used in aviation during fiscal year 2011, and (6) the amount of net excise taxes distributed to the HTF during fiscal year 2011. The enclosure provides more detail on the agreed-upon procedures and our results.

We were not engaged to perform, and did not perform, an examination, the objective of which would have been to express an opinion on the amount of net excise taxes distributed to the HTF during fiscal year 2011. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that we would have reported to you. We completed the agreed-upon procedures on October 26, 2011.

We provided a draft of this letter, along with the enclosure, to IRS and OTA officials for review and comment. IRS and OTA agreed with the results and findings presented in the enclosure relating to each agency's respective responsibilities as it pertains to excise tax distributions to the HTF during fiscal year 2011.

This report is intended solely for the use of the Office of Inspector General of the U.S. Department of Transportation and should not be used by those who have not agreed to the procedures or have not taken responsibility for the sufficiency of the procedures for their purposes.

Next is a description of two procedures performed selected from the enclosure to the GAO report.

**Procedure 1**

Compare the assessment amounts for diesel fuel tax and gasoline tax, abstracts 60 and 62, respectively, from the tax return to Internal Revenue Service's master file for agreement.

**Description of Findings and Results 1**

The assessment amounts for diesel fuel tax and gasoline tax, abstracts 60 and 62, respectively, on the tax return, agreed with the master file for all 21 returns containing primarily HTF-related tax liabilities.

**Procedure 2**

Calculate the assessment amounts on the tax return for the selected abstracts to determine whether they are mathematically correct.

**Description of Findings and Results 2**

The taxpayers' calculations for the selected abstracts were mathematically correct on all 21 returns containing primarily HTF-related tax liabilities.

---

*Source: GAO-12-139R, Fiscal Year 2011 Agreed-Upon Procedures for Excise Tax Distributions to the Highway Trust Fund, November 3, 2011.*

not made fully aware of the nature of the service, the auditor risks being called on the carpet and asked to justify the value of the services provided.

To avoid these issues, it is important that the client is made aware of the auditor's role and specifically the lack of the auditor's opinion. It is important that this matter be thoroughly discussed with the client and documented in an engagement letter signed by the auditor and the client. The engagement letter should include the procedures to be performed. In this respect, the need to carefully evaluate the procedures cannot be over-emphasized. Informing the client on after-the-fact basis that a certain procedure is contrary to AICPA attestation guidance can be very embarrassing.

**Reports on Internal Controls**

AT Section 501 addresses reporting on internal controls over financial reporting concurrent with the execution of a related audit of the financial statements. Reports on internal controls have always been an integral part of reports that comply with the Yellow Book. Even though these reports are not new to the commercial arena, they did not become common until the creation of the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC) and PCAOB requirements that the auditor's report on SEC filings contain opinions on internal controls over financial reporting.

While certain Federal Agencies receive opinions on internal control as part of their annual audit, the most common practice, sanctioned by the Office of Management and Budget (OMB), is to allow the issuance of a disclaimer in the auditor's report on internal controls. A sample OMB-sanctioned report on internal controls (including a disclaimer) appeared in the appendix to Chapter 12.

In general, an audit of internal controls follows the same phases as a financial statement audit and, in fact, is incorporated with the procedures being performed to issue an

opinion on the financial statements. In developing the scope for a first-time audit of internal controls, the extent to which the auditor had in the past relied on internal controls to audit the entity's financial statements determines the expanded procedures to be performed.

A financial audit evaluates systems of internal controls for the purpose of issuing an opinion on the financial statements. When executing a financial statement audit, the auditor chooses the most effective combination of internal control reliance (and related testing) and substantive account balance testing. When issuing an opinion on internal control, the auditor considers the initial evaluations and performs additional procedures as necessary to support his or her opinion. It is anticipated that the more the auditor relies upon a system, the less work will be required to support an opinion on controls since there is a presumption that systems worthy of high reliance will be heavily tested by the auditor. By contrast, where the auditor decides that substantive testing is more efficient, the auditor may need to expand his or her scope beyond mere compliance with the Yellow Book requirement to test all significant systems regardless of the auditor's decision to rely on substantive procedures. Finally, where the auditor determines that the system is not reliable, he or she must consider this factor in deciding whether this weakness requires a departure from a clean opinion (e.g., qualified, adverse, or in certain cases disclaimed).

The reader is referred to Chapters 9 through 12 of this book and AT 501 for further guidance. In Exhibit 16.4, we have included a sample clean opinion adapted to a Federal Agency and designed to comply with the example in AT 501.169

#### **EXHIBIT 16.4 Independent Auditor's Report on Internal Control**

We have examined [Federal Agency]'s internal control over financial reporting as of September 30, XXXX, based on based on criteria established under 31 U.S.C. § 3512 (c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA). [Federal Agency]'s management is responsible for maintaining effective internal control over financial reporting and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying management's assertion on internal control. Our responsibility is to express an opinion on [Federal Agency]'s internal control over financial reporting based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants and applicable standards contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included

performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection of and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, [Federal Agency] maintained, in all material aspects, effective internal control over financial reporting as of September 30, XXXX, based on criteria established under 31 U.S.C. § 3512 (c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA).

We have also audited, in accordance with auditing standards generally accepted in the United States of America and applicable standards contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of [Federal Agency] and our report dated [date of report, which should be the same as the date of the report on the examination of internal control] expressed [include nature of opinion].

[Signature]

[Date]

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