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Jack Blake; -

The GAO document referred to in Tooke Ross report. You may keep it.

Harold

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STANDARDS FOR AUDIT OF GOVERNMENTAL ORGANIZATIONS, PROGRAMS, ACTIVITIES & FUNCTIONS

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES
1972

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FOREWORD

In earlier and simpler times in our Nation's history, when the responsibilities of each level of government could be more clearly divided, each level could work fairly independently. Today, profound changes in our social, political, and economic order have brought steadily mounting demands for new and better public services in a variety and on a scale unprecedented in our history. Response to these demands requires a process of policymaking, financing, and administration which involves the cooperation of Federal, State, and local governments in solving public problems. Thus the Federal system of government today rests on an elaborate structure of interlocking relationships among all levels of government--between the executive and legislative branches of each, between the Federal and the State Governments, and between both and the local communities--for the conduct of programs designed to improve the quality of American life.

Accompanying this increased complexity in the relationship among the various levels of government has been an increased demand for information about government programs. Public officials, legislators, and the general public want to know whether governmental funds are handled properly and in compliance with existing laws and whether governmental programs are being conducted efficiently, effectively, and economically. They also want to have this information provided, or at least concurred in, by someone who is not an advocate of the program but is independent and objective.

This demand for information has widened the scope of governmental auditing so that such auditing no longer is a function concerned primarily with financial operations. Instead, governmental auditing now is also concerned with whether governmental organizations are achieving the purposes for which programs are authorized and funds are made available, are doing so economically and efficiently, and are complying with applicable laws and regulations. The standards contained in this statement were developed to apply to audits of this wider scope. These standards are intended to be applicable to all levels of government in the United States.

The survey and research work on which the accompanying statement is based was conducted by an interagency working group composed of representatives of the General Accounting Office and the Federal executive departments and agencies having the predominance of Federal grant programs. Assistance was also obtained from audit representatives of the State, county, and city governments visited during the course of the work and from leading professional organizations,

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including the American Institute of Certified Public Accountants, the Institute of Internal Auditors, the Federal Government Accountants Association, the Municipal Finance Officers Association, and the American Accounting Association.

Consultative assistance was provided by university consultants; the Advisory Commission on Intergovernmental Relations; a consultant selected from one State, county, and city; and public interest groups generally representing State and local governments. Among the public interest groups participating were the Council of State Governments, the National Association of Counties, the National League of Cities, the United States Conference of Mayors, and the International City Management Association.

The General Accounting Office, on October 1, 1968, issued a statement entitled "Internal Auditing in Federal Agencies," which set forth the basic principles and concepts to be followed by Federal agencies in developing and operating their internal audit organizations. The purpose of that statement was to describe the role of the internal auditor in the Federal Government, the scope of his work, his proper location in the organizational structure, and related matters. We plan to amend that statement in the near future to incorporate the auditing standards that follow.

Elmer B. Staats

Comptroller General
of the United States

June 1972

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PART I--INTRODUCTION

PURPOSE

This statement contains a body of audit standards that are intended for application to audits of all government organizations, programs, activities, and functions--whether they are performed by auditors employed by Federal, State, or local Governments; independent public accountants; or others qualified to perform parts of the audit work contemplated under these standards. These standards are also intended to apply to both internal audits and audits of contractors, grantees, and other external organizations performed by or for a governmental entity. These audit standards relate to the scope and quality of audit effort and to the characteristics of a professional and meaningful audit report.

The American Institute of Certified Public Accountants (AICPA) has adopted standards and procedures that are applicable to audits performed to express opinions on the fairness with which financial statements present the financial position and results of operations.[1] These standards are generally accepted for such audits and have been incorporated into this statement. However, the interests of many users of reports on Government audits are broader than those that can be satisfied by audits performed to establish the credibility of financial reports. To provide for audits that will fulfill these broader interests, the standards in this statement include the essence of those prescribed by the American Institute of Certified Public Accountants and additional standards for audits of a broader scope as will be explained subsequently.

SCOPE

A fundamental tenet of a democratic society holds that governments and agencies entrusted with public resources and the authority for applying them have a responsibility to render a full accounting of their activities. This accountability is inherent in the governmental process and is not always specifically identified by legislative provision. This governmental accountability should identify not only

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[1] The basic standards are included in "Statements on Auditing Procedure No. 33," issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants.

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the objects for which the public resources have been devoted but also the manner and effect of their application.

This concept of accountability is woven into the basic premises supporting these standards. These standards provide for a scope of audit that includes not only financial and compliance auditing but also auditing for economy, efficiency, and achievement of desired results. Provision for such a scope of audit is not intended to imply that all audits are presently being conducted this way or that such an extensive scope is always desirable. However,an audit that would include provision for the interests of all potential users of government audits would ordinarily include provision for auditing all the above elements of the accountability of the responsible officials.

Definitions of the three elements of such an audit follow.

1. Financial and compliance--determines (a) whether financial operations are properly conducted, (b) whether the financial reports of an audited entity are presented fairly, and (c) whether the entity has complied with applicable laws and regulations.

2. Economy and efficiency--determines whether the entity is managing or utilizing its resources (personnel, property, space, and so forth) in an economical and efficient manner and the causes of any inefficiencies or uneconomical practices, including inadequacies in management information systems, administrative procedures, or organizational structure.

3. Program results--determines whether the desired results or benefits are being achieved, whether the objectives established by the legislature or other authorizing body are being met, and whether the agency has considered alternatives which might yield desired results at a lower cost.

The audit standards are intended to be more than the mere codification of current practices, tailored to existing audit capabilities. Purposely forward-looking, these standards include some concepts and areas of audit coverage which are still evolving in practice but which are vital to the accountability objectives sought in the audit of governments and of intergovernmental programs. Therefore the audit standards have been structured so that each of the three elements of audit can be performed separately if this is deemed desirable.

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It should be recognized that a concurrent audit of all three parts would probably be the most economical manner of audit, but often this may not be practical. Furthermore, it may not be practical or necessary to perform all three elements of the audit in particular circumstances. For most government programs or activities, however, the interests of many potential government users will not be satisfied unless all three elements are performed.

In memorandums of engagements between governments and independent public accountants or other audit organizations, the arrangements should specifically identify whether all, or specifically which, of the three elements of the audit are to be conducted. Such agreements are needed to ensure that the scope of audit to be made is understood by all concerned.

BASIC PREMISES

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

1. The term "audit" may be used to describe not only work done by accountants in examining financial reports but also work done in reviewing (a) compliance with applicable laws and regulations, (b) efficiency and economy of operations, and (c) effectiveness in achieving program results.

2. Public office carries with it the responsibility to apply resources in an efficient, economical, and effective manner to achieve the purposes for which the resources were furnished. This responsibility applies to all resources, whether entrusted to the public officials by their own constituency or by other levels of government.

3. A public official is accountable to those who provide the resources he uses to carry out governmental programs. He is accountable both to other levels of government for the resources such levels have provided and to the electorate, the ultimate source of all governmental funds. Consequently he should be providing appropriate reports to those to whom he is accountable. Unless legal restrictions or other valid reasons prevent him from doing so, the auditor should make the results of audits available to other

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levels of government that have supplied resources and to the electorate.

4. Auditing is an important part of the accountability process since it provides independent judgments of the credibility of public officials' statements about the manner in which they have carried out their responsibilities. Auditing also can help decisionmakers improve the efficiency, economy, and effectiveness of governmental operations by identifying where improvements are needed.

5. The interests of individual governments in many financially assisted programs often cannot be isolated because the resources applied have been commingled. Different levels of government share common interests in many programs. Therefore an audit should be designed to satisfy both the common and discrete accountability interests of each contributing government.

6. Cooperation by Federal, State, and local governments in auditing programs of common interest with a minimum of duplication is of mutual benefit to all concerned and is a practical method of auditing intergovernmental operations.

7. Auditors may rely upon the work of auditors at other levels of government if they satisfy themselves as to the other auditors' capabilities by appropriate tests of their work or by other acceptable methods.

An inherent assumption that underlies all the standards is that governments will cooperate in making audits in which they have mutual interests. For many programs that are federally assisted, it would be neither practical nor economical to have every auditor at every level of government do his own background research on the laws, regulations, objectives, and goals of his segment of the program. Therefore, to provide the auditor with the necessary background information and to guide his judgment in the application of the accompanying standards, Federal or State agencies that request State, local, or other levels to make audits are expected to prepare broad, comprehensive audit instructions, tailored to particular programs or program areas.

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The content of such audit guidance should include a digest of, or as a minimum, citations to applicable statutes, regulations, instructions, manuals, grant agreements, and other program documents; identification of specific audit objectives and reporting requirements in terms of matters of primary interest in such areas as program compliance, economy, and effectiveness; and other audit guidelines covering specific areas in which the auditor is expected to perform.

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PART II--SUMMARY

Part II is a summary of the standards. Parts III, IV, and V explain the standards more fully.

PART III--GENERAL STANDARDS

1. The full scope of an audit of a governmental program, function, activity, or organization should encompass:

   a. An examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations.

   b. A review of efficiency and economy in the use of resources.

   c. A review to determine whether desired results are effectively achieved.

   In determining the scope for a particular audit, responsible officials should give consideration to the needs of the potential users of the results of that audit.

2. The auditors assigned to perform the audit must collectively possess adequate professional proficiency for the tasks required.

3. In all matters relating to the audit work, the audit organization and the individual auditors shall maintain an independent attitude.

4. Due professional care is to be used in conducting the audit and in preparing related reports.

PART IV--EXAMINATION AND EVALUATION STANDARDS

1. Work is to be adequately planned.

2. Assistants are to be properly supervised.

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3. A review is to be made of compliance with legal and regulatory requirements.

4. An evaluation is to be made of the system of internal control to assess the extent it can be relied upon to ensure accurate information, to ensure compliance with laws and regulations, and to provide for efficient and effective operations.

5. Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditor's opinions, judgments, conclusions, and recommendations.

PART V--REPORTING STANDARDS

1. Written audit reports are to be submitted to the appropriate officials of the organizations requiring or arranging for the audits. Copies of the reports should be sent to other officials who may be responsible for taking action on audit findings and recommendations and to others responsible or authorized to receive such reports. Copies should also be made available for public inspection.

2. Reports are to be issued on or before the dates specified by law, regulation, or other arrangement and, in any event, as promptly as possible so as to make the information available for timely use by management and by legislative officials.

3. Each report shall:

   a. Be as concise as possible but, at the same time, clear and complete enough to be understood by the users.

   b. Present factual matter accurately, completely, and fairly.

   c. Present findings and conclusions objectively and in language as clear and simple as the subject matter permits.

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d. Include only factual information, findings, and conclusions that are adequately supported by enough evidence in the auditor's working papers to demonstrate or prove, when called upon, the bases for the matters reported and their correctness and reasonableness. Detailed supporting information should be included in the report to the extent necessary to make a convincing presentation.

e. Include, when possible, the auditor's recommendations for actions to effect improvements in problem areas noted in his audit and to otherwise make improvements in operations. Information on underlying causes of problems reported should be included to assist in implementing or devising corrective actions.

f. Place primary emphasis on improvement rather than on criticism of the past; critical comments should be presented in balanced perspective, recognizing any unusual difficulties or circumstances faced by the operating officials concerned.

g. Identify and explain issues and questions needing further study and consideration by the auditor or others.

h. Include recognition of noteworthy accomplishments, particularly when management improvements in one program or activity may be applicable elsewhere.

i. Include recognition of the views of responsible officials of the organization, program, function, or activity audited on the auditor's findings, conclusions, and recommendations. Except where the possibility of fraud or other compelling reason may require different treatment, the auditor's tentative findings and conclusions should be reviewed with such officials. When possible, without undue delay, their views should be obtained in writing and objectively considered and presented in preparing the final report.

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j. Clearly explain the scope and objectives of the audit.

k. State whether any significant pertinent information has been omitted because it is deemed privileged or confidential. The nature of such information should be described, and the law or other basis under which it is withheld should be stated.

4. Each audit report containing financial reports shall:

a. Contain an expression of the auditor's opinion on whether the information contained in the financial reports is presented fairly. If the auditor cannot express an opinion, the reasons therefor should be stated in the audit report.

b. State whether the financial reports have been prepared in accordance with generally accepted or prescribed accounting principles applicable to the organization, program, function, or activity audited and on a consistent basis from one period to the next. Material changes in accounting policies and procedures and their effect on the financial reports are to be explained in the audit report.

c. Contain appropriate supplementary explanatory information about the contents of the financial reports as may be necessary for full and informative disclosure about the financial operations of the organization, program, function, or activity audited. Violations of legal or other regulatory requirements, including instances of noncompliance, shall be explained in the audit report.

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PART III--GENERAL STANDARDS

CHAPTER 1

SCOPE OF AUDIT WORK

The first general standard for governmental auditing is:

> The full scope of an audit of a governmental program, function, activity, or organization should encompass:
>
> 1. An examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations.
>
> 2. A review of efficiency and economy in the use of resources.
>
> 3. A review to determine whether desired results are effectively achieved.
>
> In determining the scope for a particular audit, responsible officials should give consideration to the needs of the potential users of the results of the audit.

This standard places on officials who authorize and prescribe the scope of governmental audits the responsibility for providing for audit work that is broad enough to fulfill the needs of all potential users of the results of such audits. The standard is not intended to prevent such officials from authorizing specific assignments of parts of the total scope of the audit work required by the standard or from authorizing special audits, nor is it intended to prevent auditors from performing such audits. However, those responsible for authorizing governmental audits are charged with the knowledge that, for most governmental programs, their full responsibility for obtaining audit work is not discharged unless the full scope of audit work set forth in the standard is performed.

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The general objectives of the above categories of audit work are as follows:

1. Examinations of financial transactions, accounts, and reports and compliance with applicable laws and regulations shall include sufficient audit work to determine whether:

   a. The audited entity is maintaining effective control over revenues, expenditures, assets, and liabilities.

   b. The audited entity is properly accounting for resources, liabilities, and operations.

   c. The financial reports contain accurate, reliable, and useful financial data and are fairly presented.

   d. The entity is complying with the requirements of applicable laws and regulations.

2. A review of efficiency and economy shall include inquiry into whether, in carrying out its responsibilities, the audited entity is giving due consideration to conservation of its resources and minimum expenditure of effort. Examples of uneconomical practices or inefficiencies the auditor should be alert to include:

   a. Procedures, whether officially prescribed or merely followed, which are ineffective or more costly than justified.

   b. Duplication of effort by employees or between organizational units.

   c. Performance of work which serves little or no useful purpose.

   d. Inefficient or uneconomical use of equipment.

   e. Overstaffing in relation to work to be done.

   f. Faulty buying practices and accumulation of unneeded or excess quantities of property, materials, or supplies.

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g. Wasteful use of resources.

Efficiency and economy are both relative terms and it is virtually impossible to give an opinion as to whether an organization has reached the maximum practicable level of either. Therefore it is not contemplated in these standards that the auditor will be called upon to give such an opinion.

3. A review of the results of programs or activities shall include inquiry into the results or benefits achieved and whether the programs or activities are meeting established objectives. The auditor should consider:

   a. The relevance and validity of the criteria used by the audited entity to judge effectiveness in achieving program results.

   b. The appropriateness of the methods followed by the entity to evaluate effectiveness in achieving program results.

   c. The accuracy of the data accumulated.

   d. The reliability of the results obtained.

In some cases an auditor may be asked to participate in a program evaluation effort by accumulating data himself for evaluation of a program or activity under audit. When such work is to be done on a coordinated basis, the evaluation techniques should be uniformly prescribed for the whole program at some central level. The auditors at the various program sites should only be required to accumulate data and compare it with the prescribed measures. To do otherwise would be economically unfeasible and would lead to wide variations in the measurements applied to similar projects by different auditors.

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CHAPTER 2

QUALIFICATIONS

The second general standard for governmental auditing is:

> The auditors assigned to perform the audit must collectively possess adequate professional proficiency for the tasks required.

This standard places upon the auditor the responsibility for ensuring that the audit is conducted by personnel who collectively have the skills necessary for the type of audit that is to be performed.

The qualifications of the staff assigned to the audit should be commensurate with the scope and complexities of their audit assignments. Audits vary in purpose and scope. Some require an opinion on financial statements and the evaluation of compliance with specific laws and other requirements; others require reviews of efficiency and economy or effectiveness in achieving program results; still others require some or all of these three elements of audit work. Performing all three elements of audit work, in some cases, will require a wide variety of skills. The need for diverse skills may require cooperative audits by different audit organizations whose personnel collectively have the required capabilities.

Because there are variations in program objectives and organizational forms, as well as differences in laws, rules, and regulations applicable to such programs, the qualifications mentioned herein should apply to the skills of the audit organization as a whole and not necessarily to individual auditors. Thus, if an organization possesses personnel or consultants with acceptable skills in accounting, statistics, law, engineering, actuarial science, and related skills, each individual member of the organization need not himself possess all of these skills.

Requirements for staffs performing government audits are:

1. A basic knowledge of auditing theory and procedures and the education, ability, and experience to apply

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such knowledge to the type of auditing work required for the task at hand.

2. A basic knowledge of governmental organization and operation. This knowledge may be acquired by appropriate education, study, or experience.

3. Skills appropriate for the work required in the audit. For auditing financial reports which lead to an opinion, the auditor must be proficient in accounting. Language setting forth the qualifications for independent public accountants who wish to perform such work is included in appendix I. For other types of auditing work, the skills of the auditors must be appropriate for the work to be done. For instance:

   a. If the work requires use of statistical techniques, the audit staff must include persons having the appropriate statistical skills. These skills may be possessed by staff members or by consultants to the staff.

   b. If the work requires extensive review of computerized systems, the audit staff must include persons having the appropriate computer skills. These skills may be possessed by staff members or by consultants to the staff.

   c. If the work involves review into complex engineering data, the audit staff must include persons having the appropriate engineering skills. These skills may be possessed by staff members or by consultants to the staff.

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CHAPTER 3

INDEPENDENCE

The third general standard for governmental auditing is:

> In all matters relating to the audit work, the audit organization and the individual auditors shall maintain an independent attitude.

This standard places upon the auditor and the audit organization the responsibility for maintaining sufficient independence so that their opinions, conclusions, judgments, and recommendations will be impartial. If the auditor is not sufficiently independent to produce unbiased opinions, conclusions, and judgments, he should state in a prominent place in the audit report his relationship with the organization or officials being audited.[1]

The auditor should consider not only whether his own attitudes and beliefs permit him to be independent but also whether there is anything about his situation which would lead others to question his independence. Both situations deserve consideration since it is important not only that the auditor be, in fact, independent and impartial but also that other persons will consider him so.

There are three general classes of impairments that the auditor needs to consider; these are personal, external, and organizational impairments. If one or more of these are of such significance as to affect his ability to perform his work and report its results impartially, he should decline to perform the audit or indicate in his report that he was not fully independent.

PERSONAL IMPAIRMENTS

There are some circumstances in which an auditor cannot be impartial because of his views or his personal situation. These circumstances might include:

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[1] If the auditor is not fully independent because he is an employee of the audited entity, it will be adequate disclosure to so indicate. If the auditor is a practicing certified public accountant, his conduct should be governed by the AICPA "Statements on Auditing Procedure."

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1. Relationships of an official, professional, and/or personal nature that might cause the auditor to limit the extent or character of his inquiry, to limit disclosure, or to weaken his findings in any way.

2. Preconceived ideas about the objectives or quality of a particular operation or personal likes or dislikes of individuals, groups, or objectives of a particular program.

3. Previous involvement in a decisionmaking or management capacity in the operations of the governmental entity or program being audited.

4. Biases and prejudices, including those induced by political or social convictions, which result from employment in or loyalty to a particular group, entity, or level of government.

5. Actual or potential restrictive influence when the auditor performs preaudit work and subsequently performs a post audit.

6. Financial interest, direct or indirect, in an organization or facility which is benefiting from the audited programs.

EXTERNAL IMPAIRMENTS

External factors can restrict the audit or impinge on the auditor's ability to form independent and objective opinions and conclusions. For example, under the following conditions either the audit itself could be adversely affected or the auditor would not have complete freedom to make an independent judgment.[1]

1. Interference or other influence that improperly or imprudently eliminates, restricts, or modifies the scope or character of the audit.

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[1]Some of these situations may constitute justifiable limitations on the scope of the work. In such cases the limitation should be identified in the auditor's report.

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2. Interference with the selection or application of audit procedures or the selection of activities to be examined.

3. Denial of access to such sources of information as books, records, and supporting documents or denial of opportunity to obtain explanations by officials and employees of the governmental organization, program, or activity under audit.

4. Interference in the assignment of personnel to the audit task.

5. Retaliatory restrictions placed on funds or other resources dedicated to the audit operation.

6. Activity to overrule or significantly influence the auditor's judgment as to the appropriate content of the audit report.

7. Influences that place the auditor's continued employment in jeopardy for reasons other than competency or the need for audit services.

8. Unreasonable restrictions on the time allowed to competently complete an audit assignment.

ORGANIZATIONAL IMPAIRMENTS

The auditor's independence can be affected by his place within the organizational structure of governments. Auditors employed by Federal, State, or local government units may be subject to policy direction from superiors who are involved either directly or indirectly in the government management process. To achieve maximum independence, such auditors and the audit organization itself not only should report to the highest practicable echelon within their government but should be organizationally located outside the line-management function of the entity under audit.

These auditors should also be sufficiently removed from political pressures to ensure that they can conduct their auditing objectively and can report their conclusions completely without fear of censure. Whenever feasible they

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should be under a system which will place decisions on compensation, training, job tenure, and advancement on a merit basis.

When independent public accountants or other independent professionals are engaged to perform work that includes inquiries into compliance with applicable laws and regulations, efficiency and economy of operations, or achievement of program results, they should be engaged by someone other than the officials responsible for the direction of the effort being audited. This practice removes the pressures that may result if the auditor must criticize the performance of those who engaged him. To remove this obstacle to independence, governments should arrange to have such auditors engaged by officials not directly involved in operations to be audited.

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CHAPTER 4

DUE PROFESSIONAL CARE

The fourth general standard for governmental auditing is:

> Due professional care is to be used in conducting the audit and in preparing related reports.

This standard places upon the auditor and the audit organization the responsibility for employing high professional standards in performing the work required in making examinations of governmental entities.

This standard does not imply unlimited responsibility for disclosure of irregularities or noncompliance; neither does it imply infallibility on the part of either the audit organization or the individual auditor. The standard does require professional performance of a quality appropriate for the complexities of the audit assignment undertaken.

The standard imposes upon the auditor a requirement to be alert for situations or transactions that could be indicative of fraud, improper or illegal expenditures or operations, inefficiency, waste, or lack of effectiveness. It does not, however, require that the auditor give absolute assurance that no material impropriety exists; nor does it require that a detailed audit of all transactions normally be undertaken.

The audit process should not be considered as a substitute for internal control. It is management's responsibility to institute adequate procedures and controls to prevent irregularities and improprieties and to encourage adherence to adopted policies and prescribed requirements. Auditing is primarily a test of these procedures and controls and is not a substitute for them.

Exercising due professional care means using good judgment in the choice of tests and procedures and doing a good job in applying them and in preparing reports. As a minimum the choice of tests and procedures requires consideration of:

1. What is necessary to achieve the audit objectives.

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2. Relative materiality or importance of matters to which the procedures will be applied.

3. Effectiveness of internal controls.

4. Cost of the work being performed in relation to the benefits to be derived.

The quality of audit work and related reports depends upon the degree to which:

1. Tests and procedures are properly applied by competent persons.

2. Findings and conclusions are based on an objective evaluation of all pertinent facts.

3. Factual statements and conclusions contained in reports are fully supported by information obtained or developed during the audit.

4. The audit process conforms with the examination and evaluation standards prescribed in part IV and the reporting standards prescribed in part V.

5. A critical review is performed at every level of supervision of the work done and of the judgment exercised by those assisting in the examination.

Due professional care also includes obtaining a mutual understanding of the audit scope and objectives with the audited entity and those authorizing the audit if different from the entity. It also includes obtaining a good working understanding of the operations to be audited and any available underlying criteria of performance (including pertinent laws and regulations) to be utilized for evaluation purposes. When the established criteria for performance are vague, the auditor should attempt to obtain authoritative interpretation of the criteria. If the auditor is required to select measurement criteria, he should strive to reach agreement on the appropriateness of these measures with the interested parties.

Due professional care also includes followup work on findings resulting from similar audits made previously to determine whether appropriate corrective measures have been taken.

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PART IV--EXAMINATION AND EVALUATION STANDARDS

CHAPTER 1

PLANNING

The first examination and evaluation standard for governmental auditing is:

Work is to be adequately planned.

This standard places upon the auditor or audit organization the responsibility for performing sufficient advance planning to provide a basis for an effective audit. The auditor should see that necessary or desired work steps are systematically laid out so that they can be understood by all levels in the audit structure, which will minimize the expenditure of staff time and resources on unnecessary work.

Planning in intergovernmental auditing is especially important because, in many instances, the audit work performed at one level of government should be correlated with work performed at other levels of government, all or some of which may have an interest in, or a statutory requirement to review, the discharge of financial, management, or program accountability of a single organization, function, activity, or program. When such correlation is necessary, it is essential that planning be done by some central agency which will set the objectives of the work so that the scope of the participatory audits done at individual program sites will be comparable and the results can be consolidated.

Where the required work includes reviews into the efficiency, economy, or achievement of desired results, adequate planning is especially important because the procedures employed in such audits are more varied and complex and, thus, more care is needed to select the appropriate procedures for the case at hand. Finally, planning is important to ensure that the results of the audit will satisfy the objectives of the audit.

Adequate planning should include planning for:

1. Coordination with other governmental auditors, when appropriate.

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2. Personnel to be used on the assignment.

3. Work to be performed.

4. The format and general content of the report to be issued.

COORDINATION

In governmental auditing there frequently is a need for participatory audit work by groups of auditors at different locations who often are associated with an entity other than the one directing the auditors planning the audit work. This situation frequently involves audits of Federal grants under which the grantee is required to have audits made and to provide reports on such audits to the grantor. The situation also arises when a central audit agency having several field offices makes an audit of a program or activity that is being carried out at various locations and uses its field offices to make the audits at specific locations. Very careful planning by the central agency directing the audit is necessary if such audits are to be performed effectively and economically.

Planning for such coordinated audits must be tailored to the specific objectives of the audit. Ordinarily the central agency should specify such things as the laws and regulations that are to be considered by the auditor in reviewing compliance; the goals, objectives, and criteria of the program that are to be used in the review of program results; and the particular aspects of economy and efficiency that are to be considered in that part of the audit. Unless such planning is carefully performed and communicated to the participating audit staffs, the results of the audit are likely to be below the needs and expectations of the central agency. Unplanned audit effort also will offer difficult problems in comparing or consolidating the results of audits from various locations.

Furthermore, much of the planning necessary for a coordinated audit can only be done efficiently and economically at the central-agency level. Researching the laws and regulations applicable to a program and presenting clear, concise audit objectives is challenging and time-consuming work. To leave such work to each participating audit staff would result in excessive duplication and hence unacceptable additional cost. Moreover, some audits in which part of a transaction must be audited at one location and part at

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another require even closer coordination if more than one audit staff does the work. The preparation of detailed guides for such audits is an integral part of the standard that audits should be properly planned.[1]

MULTIPLE-USE AUDITS

In some cases audits of the same programs may be required by Federal law or regulation, State law or regulation, and/or municipal ordinances. Whenever practicable, planning for such audits should include planning for the requirements of all levels of government with the objective of making one audit serve the needs of all interested governmental levels.

PERSONNEL

Planning for use of personnel should include:

1. Assigning qualified staff having education and experience commensurate with the nature of the audit work required to be performed.

2. Efficiently employing the staff, including the assignment of a sufficient number of experienced workers and appropriate numbers and levels of supervisors. The planning should also include securing the services of outside consultants when necessary.

3. Providing appropriate on-the-job training for inexperienced personnel.

WORK TO BE PERFORMED

A written audit program should be prepared for each audit to provide for effective communication of the objectives of the audit to all staff members, to facilitate control of the audit work during the review phase, and to provide a permanent record of the audit plan. The information needed

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[1] A publication issued in 1972 by the American Institute of Certified Public Accountants provides guidance for use in preparation of audit guides. The publication is entitled "Suggested Guidelines for the Structure and Content of Audit Guides Prepared by Federal Agencies For Use by CPA's."

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by the auditor to prepare a satisfactory audit program should vary with the types of audit and the entities to be audited; however, in most cases it is advisable to precede the preparation of the audit program with a survey of the entity to be audited to obtain basic working information about its operations and practices.

A skillfully performed survey should provide information about the size and scope of the entity's activities and any areas in which there may be weaknesses in internal controls, uneconomical or inefficient operations, lack of effectiveness in achieving prescribed goals, or lack of compliance with applicable laws and regulations. However, tests to determine the significance of such matters are to be performed in the detailed audit work and should be carefully set out in the audit program.

The audit program should ordinarily provide such information as:

1. Purpose and scope--The purpose of the audit and its scope should be described, and information should be provided as to whether the work is to include one or more of the three elements of an audit--financial and compliance, economy and efficiency, or program results.

2. Background--Information should be provided about the legal authority for the existence and operation of the organization, program, function, or activity to be audited, its sources of revenue, principal locations, and similar items needed to understand the objectives and operational characteristics of its work.

3. Definition of terms--Definitions and explanations should be included for any unique terms or abbreviations used by the audited organization, program, activity, or function.

4. Objectives of the audit--A carefully drawn statement of what the auditor is expected to produce as a result of his audit should be provided. This statement should be clearly expressed--ambiguous words should be carefully avoided--so that the auditor knows on what issues he is expected to reach conclusions. In financial and compliance audits, the

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financial reports to be examined should be specified and the principal laws and regulations to which compliance is to be determined should be specified. In audits of program results, the criteria prescribed for evaluating the effectiveness of the program should be clearly set out.

5. Procedures--For many audits it is desirable to prescribe procedures for the auditor to follow in achieving the audit objectives. When multilocation programs involving program effectiveness are to be performed at a number of locations, the audit organization planning the work centrally should ordinarily prescribe very specific methods to be followed in the examination to be sure that the data obtained from all participating locations will be comparable. However, this should be done in a manner that does not restrict the auditor's professional judgment. Audit programs should never be used as a blind checklist or in a way that stifles initiative, imagination, and thoroughness in performing an audit.

6. Report--The audit program should set forth the general format to be followed in the auditor's report and a general discussion of the type of information desired in it.

ACCESS TO WORKING PAPERS

Arrangements should be made to ensure that working papers will be made available upon request to other governmental audit staffs and auditors who follow at later dates. A provision relative to access of working papers should be written into all contractual arrangements for governmental audits.

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CHAPTER 2

SUPERVISION

The second examination and evaluation standard for governmental auditing is:

> Assistants are to be properly supervised.

This standard places upon the auditor or audit organization the responsibility for ensuring that less skilled staff members receive appropriate guidance in the performance of their work.

The most effective way to control the quality and to expedite the progress of an assignment is by exercising proper supervision from the start of the preparatory work to the completion of the report draft. Supervision adds seasoned judgment to the work performed by less experienced members of the staff and provides necessary training for such staff members.

The assignment and use of assistants is an important factor in achieving the established objectives in a satisfactory manner. Since training, experience, and other qualifications vary among auditors, specific work assignments must be commensurate with abilities.

Supervisors should see that assistants have a clear understanding of their assigned tasks before they start the work. Assistants should be informed not only of what work they are to do and the way they are to proceed but also of what the work is expected to accomplish. With a seasoned staff the supervisor's part may be more general in character. He may outline the broad course of the work and leave details to assistants. With a less experienced staff the supervisor may have to go into many of the details himself and instruct his staff specifically as to what they are to do and how they are to do it.

Supervisory review should be directed to both the substance and the method of auditing. The review should ensure that (1) conformance with audit standards is obtained, (2) the audit programs are followed, unless deviation is justified and authorized, (3) the working papers adequately support findings and conclusions, (4) the working papers

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provide adequate data to prepare a meaningful report, and (5) the auditor will accomplish the audit objectives. Documentation of supervisory reviews should be prepared and retained.

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CHAPTER 3

LEGAL AND REGULATORY REQUIREMENTS

The third examination and evaluation standard for governmental auditing is:

> A review is to be made of compliance with legal and regulatory requirements.

In governmental auditing, compliance with pertinent laws and regulations is particularly significant because government organizations, functions, programs, or activities are creatures of law and have more specific rules and regulations than are usually applicable to private organizations.

This standard places upon the auditor the responsibility for determining whether the organization, program, function, or activity under audit has complied with the requirements placed upon it by pertinent laws and regulations. In reviewing compliance with pertinent laws and regulations, the auditor should consider not only statutes and implementing regulations but also the related legislative history, legal opinions, court cases, and regulatory requirements, including such documents as grant or loan agreements.

When the auditor is at the central-agency level, he should ordinarily take the responsibility for determining the laws and regulations which should be considered in the audit. When grants from another level of government are involved, legal and regulatory requirements should ordinarily be obtained from that level and should be made available through audit guides to the grantee's auditor. To do otherwise would result in substantial duplicate work in cases in which there are multiple grantees. Furthermore, the grantor is familiar with these statutes and requirements and can provide them and the related supporting data with far less effort than would be required by the grantee's auditor.

In making his review, the auditor at the central-agency level should select and review those laws and regulations which have a direct bearing or a significant impact upon the entity to be audited or its operations. The laws and regulations which may apply to a specific government

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organization, program, function, or activity are often very extensive, and the auditor cannot be expected to review every law or regulation which may in some way impact on the entity. Consequently, this type of review requires considerable judgment. As a general rule, the auditor first should find out from the audited entity's management the legal and regulatory requirements it is required to follow. He then should make his own tests to determine whether any requirements are being overlooked by the entity. Some sources of information on legal and regulatory requirements follow.

1. Legal or legislative data, including:

   a. Basic legislation.

   b. Reports of hearings.

   c. Legislative committee reports.

   d. Annotated references from reference services covering related court decisions and legal opinions.

   e. Historical data relating to the movements to achieve the legislation and similar prior legislation.

   f. State constitutions, statutes, resolutions, and legislative orders.

   g. Local charters, ordinances, and resolutions.

2. External administrative requirements, including:

   a. Memorandums from Federal, State, or local administrative agencies.

   b. Guidelines and other administrative regulations affecting program operations from Federal, State, or local agencies.

3. Grant arrangements, when grants are involved, including:

   a. Proposals from grantees.

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b. Pertinent correspondence from grantors and grantees.

c. Memorandums of meetings held to discuss the grants.

d. The grant documents, including amendments.

e. Grant regulations.

f. Grant budgets and supporting schedules.

The nature and purpose of the review of legal and administrative requirements will tend to vary with the element of auditing being performed.

Financial and compliance--The auditor is to test the financial transactions and operations of the audited organization, program, function, or activity to determine whether that entity is in compliance with pertinent laws or regulations. The auditor also is to make a review to satisfy himself that the audited entity has not incurred significant unrecorded liability through failure to comply with, or through violation of, pertinent laws and regulations.

Economy and efficiency--The auditor is to make a review of the laws and regulations applying to any aspect of the audited organization, program, function, or activity in which he attempts to make a judgment regarding whether existing practices can be made significantly more efficient or economical. Such a review is needed because determinations of how the entity's tasks can be accomplished more efficiently and economically cannot be done properly without an understanding of the purpose of the entity and what it is legally required to do. Such a review is needed also to provide the auditor with information on constraints on the entity's authority to change its practices to make them more efficient and economical.

Program results--The auditor is to review the laws and regulations pertaining to the goals and objectives of the audited entity's programs or activities in sufficient depth to gain a working understanding of the results that are expected from the programs

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or activities. He must also do sufficient testing to determine whether the programs or activities are being performed in conformity with applicable laws and regulations.

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CHAPTER 4

INTERNAL CONTROL

The fourth examination and evaluation standard for governmental auditing is:

> An evaluation is to be made of the system of internal control to assess the extent it can be relied upon to ensure accurate information, to ensure compliance with laws and regulations, and to provide for efficient and effective operations.

This standard places upon the auditor the responsibility for determining how much reliance he can place on the audited entity's internal controls to ensure accurate information, ensure compliance with applicable laws and regulations, promote efficiency and economy, and produce effective results. His findings will help him determine the extent of detailed examination work he must perform to achieve the objectives of the audit.

Internal control comprises the plan of organization and all the coordinate methods and measures adopted to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. The term embraces the policies, procedures, and practices established or encouraged by management as well as the plan of organization and other measures intended to carry them out.

The characteristics of a satisfactory system of internal control would include:

1. A plan of organization that provides segregation of duties appropriate for proper safeguarding of the entity's resources.

2. A system of authorization and record procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenses.

3. An established system of practices to be followed in performance of duties and functions of each of the organizational departments.

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4. Personnel of a quality commensurate with their responsibilities.

5. An effective system of internal review.

These elements, as important as each is in its own right, are mutually reinforcing and all are so basic to adequate internal control that serious deficiencies in any one normally would preclude effective operation of the system.

A complete review of internal controls as a specific requirement would often be prohibitive in terms of available resources. Examining all such controls would not be efficient auditing because of the irrelevance of some controls to the basic issues which are the subject of the audit effort. Therefore the auditor should concentrate his attention on those controls which are important to the objectives of the audit.

The extent of work required to adequately review internal control will vary with the element of an audit being performed.

Financial and compliance--A sufficient review is to be made of internal controls to permit the auditor to determine how much reliance he can place upon the accounting records and reports to accurately portray the financial condition of the organization, program, function, or activity and to safeguard its resources. The extent of his own tests of the accounting data should be based upon his assessment of the reliability of the audited entity's internal control. The review should be sufficient to permit the auditor to determine whether policies, procedures, and practices are consistent with the applicable laws and regulations and whether the system of internal control can be relied upon to provide reasonable assurance that such policies and practices are being followed.

Efficiency and economy--The review is to include a review of policies, procedures, practices, and internal controls applicable to any aspect of the activities in which the auditor attempts to make a judgment regarding whether existing practices can be made significantly more efficient or economical.

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Program results--The auditor is to review those policies, procedures, practices, and controls which have a specific bearing on the attainment of the goals and objectives specified by the law or regulations that created the program, activity, function, or organization under audit.

Internal review is an important part of internal control and the auditor should look into such work in performing any of the three audit elements listed above. The auditor should consider the extent of the internal review work and the extent to which that work can be relied upon to ensure that other aspects of internal control are functioning properly. The auditor should take full advantage of the products of the internal review in making his audit.

In view of the wide range in the size, variety, and nature of governmental organizations, programs, activities, and functions, and in view of their organizational concepts and operating methods, no single pattern for internal review activities can be specified. Many governmental entities have internal review activities identified by other names, such as inspection, appraisal, investigation, organization and methods, and management analysis. These activities are often in the nature of management services, and in varied ways they assist management in currently supervising, advising, and reviewing designated functions. To prevent duplication of effort, all auditors--regardless of their level of government--should use, to the maximum practical extent, the work that other auditors or internal review personnel have previously performed.

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CHAPTER 5

EVIDENCE

The fifth examination and evaluation standard for governmental auditing is:

> Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditor's opinions, judgments, conclusions, and recommendations.

This standard places upon the auditor the responsibility for accumulating sufficient evidence to provide an appropriate factual basis for his opinions, conclusions, judgments, and recommendations.

Evidence needed to support the auditor's findings may be (1) physical evidence obtained by observation, photograph, or similar means, (2) testimonial evidence obtained by interviewing or taking statements from involved persons, (3) documentary evidence consisting of letters, contracts, extracts from books of account, and so forth, and (4) analytical evidence secured by analysis of information the auditor has obtained.

Regardless of the type, the evidence involved should meet the basic tests of sufficiency, competence, and relevance. The auditor's working papers should reflect the details of the evidence he has relied upon and should disclose the procedures he has employed in obtaining it.

SUFFICIENCY

Sufficiency is the presence of enough factual, adequate, and convincing evidence to lead a prudent person to the same conclusion as the auditor. Determining the sufficiency of evidence requires judgment, because there frequently is conflicting evidence and the auditor must make an impartial judgment as to what position is supported by the weight of evidence. When appropriate, statistical methods may be employed to establish sufficiency.

There is no need for elaborate documentation to support noncontroversial or insignificant points. For significant matters, however, the auditor should gather sufficient evidence to show the factors he relied upon to reach his conclusion.

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COMPETENCE

Competent evidence should be reliable and the best attainable through the use of reasonable audit methods. In evaluating the competence of evidence, the auditor should carefully consider whether there is any reason to doubt its validity or completeness. If there is reason for doubt, the auditor should take additional measures to authenticate the evidence.

The following presumptions are useful in judging the competence of evidence; however, these presumptions are not to be considered as sufficient in themselves to reach a conclusion.

1. Evidence obtained from an independent source provides greater assurance of reliability than that secured from the audit organization.

2. Evidence developed under a good system of internal control is more likely to be reliable than that obtained where such control is weak or unsatisfactory.

3. Evidence obtained by the auditor through physical examination, observation, computation, and inspection is more reliable than evidence obtained indirectly.

4. Original documents are more reliable than copies.

RELEVANCE

Relevance refers to the relationship of the information to its use. The facts and opinions used to prove or disprove an issue must have logical sensible relationship to that issue. Information which does not have this relationship is irrelevant and therefore should not be included as evidence to prove or disprove a point.

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WORKING PAPERS

Working papers serve as the connecting link between the auditor's fieldwork and his report and, as such, should contain the evidence accumulated in support of the conclusions and recommendations included in the report. Auditors should adopt reasonable procedures to ensure the safe custody and retention of their working papers for a period of time sufficient to satisfy pertinent legal and administrative requirements.

General guidelines for the preparation of working papers follow.

1. Completeness and accuracy--Working papers should be complete and accurate in order to provide proper support for findings, conclusions, and recommendations and to enable demonstration of the nature and scope of examination work, when necessary.

2. Clarity and understandability--Working papers should be clear and understandable without supplementary oral explanations. The information they reveal should be clear and complete, but concise. Anyone using the working papers should be able to readily determine their purpose, the nature and scope of the work done, and the preparer's conclusions. Conciseness is important, but clarity and completeness should not be sacrificed just to save time or paper.

3. Legibility and neatness--Working papers should be legible and as neat as practicable. Otherwise time will be wasted in reviewing them and in preparing reports. Sloppy working papers may lose their worth as evidence. Crowding and writing between lines should be avoided by anticipating space needs and arranging the working papers before writing.

4. Pertinence--The information contained in working papers should be restricted to matters which are materially important, pertinent, and useful with reference to the objectives established for the assignment. There are no substitutes for a working understanding of the specific objectives of the audit, the reasons for performing a specific task, and their relation to approved objectives. This

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knowledge comes from well-planned and well-organized work programs and effective instruction by supervisors. The practice of having all working papers contain clear statements of purpose is very helpful in ensuring that information accumulated is properly tied to audit objectives and reporting.

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PART V--REPORTING STANDARDS

CHAPTER 1

FORM AND DISTRIBUTION

The first reporting standard for governmental auditing is:

> Written audit reports are to be submitted to the appropriate officials of the organizations requiring or arranging for the audits. Copies of the reports should be sent to other officials who may be responsible for taking action on audit findings and recommendations and to others responsible or authorized to receive such reports. Copies should also be made available for public inspection.

This standard provides that a written record of the results of each governmental audit be prepared. The standard is not intended to limit or prevent discussions of findings, judgments, conclusions, and recommendations with persons who have responsibilities involving the area being audited. On the contrary, such discussions should be encouraged. However, regardless of whether such discussions are held, a written report should be prepared.

There are a number of reasons why written reports are particularly necessary. Reports should be prepared in written form (1) so that the results can be widely communicated to responsible officials at all levels of government, (2) to make the auditor's findings and recommendations less susceptible to misunderstanding, (3) to make the auditor's findings available for public inspection, and (4) to facilitate subsequent followup work to determine whether appropriate measures have been taken in response to the auditor's findings and recommendations.

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Distribution of audit reports should be to as many of the interested officials as practicable. In some cases the subject matter of the audit may involve material that is classified for security purposes or is not releasable for other valid reasons. As a general rule, however, the audit report should be distributed to those officials having a direct interest in the results of the auditor's work. Such officials include those designated by law or regulation to receive such reports; those responsible, either directly or in supervisory capacity, for taking action on the auditor's findings and recommendations; legislators; and those of other levels of government that have provided funds to the audited organization. Also, unless restricted by law or regulation, copies of audit reports should be made available for distribution to or inspection by interested members of the public.

When independent public accountants are engaged, it shall be the responsibility of the engaging organization to ensure that appropriate distribution is made to interested parties. If it is desired that the public accountants make the distribution of their report, arrangements for such distribution should be made a part of the engagement agreement indicating precisely what officials or organizations shall receive the report.

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CHAPTER 2

TIMELINESS

The second reporting standard for governmental auditing is:

> Reports are to be issued on or before the dates specified by law, regulation, or other arrangement and, in any event, as promptly as possible so as to make the information available for timely use by management and by legislative officials.

To be of maximum use, the audit report must be as timely as possible. The auditor should realize that every day delayed in issuing his report diminishes its value; therefore he should plan and conduct his work with the objective of reporting the results of his work in the shortest feasible time.

The auditor should consider interim communication of significant matters to appropriate officials during the course of his audit work. Such communication is not a substitute for a final written report, but it does alert officials to matters needing correction at an earlier date and permits these officials to instigate corrective measures earlier than is possible if the auditor's findings and recommendations are withheld until his final report is completed.

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CHAPTER 3

CONTENT

The third reporting standard for governmental auditing is:

All reports shall:

1. Be as concise as possible but, at the same time, clear and complete enough to be understood by the users.

2. Present factual matter accurately, completely, and fairly.

3. Present findings and conclusions objectively and in language as clear and simple as the subject matter permits.

4. Include only factual information, findings, and conclusions that are adequately supported by enough evidence in the auditor's working papers to demonstrate or prove, when called upon, the bases for the matters reported and their correctness and reasonableness. Detailed supporting information should be included in the report to the extent necessary to make a convincing presentation.

5. Include, when possible, the auditor's recommendations for actions to effect improvements in problem areas noted in his audit and to otherwise make improvements in operations. Information on underlying causes of problems reported should be included to assist in implementing or devising corrective actions.

6. Place primary emphasis on improvement rather than on criticism of the past; critical comments should be presented

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in balanced perspective of any unusual difficulties or circumstances faced by the operating officials concerned.

7. Identify and explain issues and questions needing further study and consideration by the auditor or others.

8. Include recognition of noteworthy accomplishments, particularly when management improvements in one program or activity may be applicable elsewhere.

9. Include recognition of the views of responsible officials of the organization, program, function, or activity audited on the auditor's findings, conclusions, and recommendations. Except where the possibility of fraud or other compelling reason may require different treatment, the auditor's tentative findings and conclusions should be reviewed with such officials. When possible, without undue delay, their views should be obtained in writing and objectively considered and presented in preparing the final report.

10. Clearly explain the scope and objectives of the audit.

11. State whether any significant pertinent information has been omitted because it is deemed privileged or confidential. The nature of such information should be described, and the law or other basis under which it is withheld should be stated.

This standard places upon the auditor the responsibility for preparing a report that will be easy to understand, will present the scope of the audit and the auditor's findings and conclusions in an objective and complete manner with appropriate support for positions taken, and will

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provide recommendations for improvement whenever feasible and appropriate.

CONCISENESS

The reports should be no longer than necessary to communicate the information the auditor is reporting. Reports should not be mired down with too much detail--words, sentences, paragraphs, or sections that do not clearly tie in with the report messages. Too much detail detracts from the reports, may even conceal the real messages and may confuse or discourage readers.

Although there is room for considerable judgment in determining the content of reports, it should be kept in mind that reports which are complete, but still concise, are more likely to receive attention.

ACCURACY, COMPLETENESS, AND FAIRNESS

Report preparation, review, and processing procedures should be applied to produce reports that contain no errors of fact, logic, or reasoning.

The need for accuracy is based on the need to be fair and impartial in reporting and to assure users and readers of reports that what is reported is reliable. One inaccuracy in a report can cast doubt on the validity of an entire report and can divert attention from the substance of the report.

Although reports should be concise, they should not be so concise that they do not fully inform the user. Reports should contain sufficient information about findings, conclusions, and recommendations to promote adequate understanding of the matters reported and to provide convincing, but fair, presentations in proper perspective. Sufficient amounts of background information should also be included.

Readers should not be expected to possess all the same facts that the auditor has, and therefore reports should not be written on the bases that the bare recitals of facts make the conclusions reached obvious or inescapable. If the auditor has conclusions or opinions that he wants the

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readers to know about, he should state them specifically rather than leave them to be inferred by the readers.

OBJECTIVITY

Findings should be presented in an objective and unbiased manner and should include sufficient information on the subject matter to provide readers with proper perspective. The objective is to produce reports which are fair and not misleading and which, at the same time, place primary emphasis on matters needing attention. The auditor should guard against the tendency to exaggerate or overemphasize deficient performance noted during his review.

The information needed to provide proper report balance and perspective should include:

1. Appropriate information as to why the examination was made.

2. Information about the size and nature of the activities or programs to which findings relate so as to provide perspective against which the significance of the findings can be judged.

3. Correct and fair descriptions of findings so as to avoid misinterpretation and misunderstanding. Information should be included on the size of tests and the methods of selecting items to test so that the readers may relate such information to the total activity and to the findings.

ADEQUATE SUPPORT

All factual data, findings, and conclusions in reports should be supported by enough objective evidence to demonstrate or prove the bases for the matters reported and their accuracy or reasonableness. Except as necessary to make convincing presentations, detailed supporting data need not be included in reports.

Opinions and conclusions in reports should be clearly identified as such and should be based on enough audit work to warrant them. In most cases one example of a deficiency cannot support a broad conclusion and a related recommendation for corrective action. All that it supports

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is the finding of the fact that there was a deviation, error, or weakness.

RECOMMENDATIONS

The auditor's report should contain appropriate recommendations whenever his review discloses that significant improvement in the audited entity is possible. He should also make recommendations to effect compliance with legal or regulatory requirements when significant instances of noncompliance are noted.

If the auditor cannot make appropriate recommendations because of limited audit scope or other reasons, he should state in his report the reason that he is unable to recommend appropriate corrective measures and what additional work would need to be done to formulate recommendations.

CONSTRUCTIVENESS OF TONE

The tone of reports should be designed to encourage favorable reaction to findings and recommendations. The titles, captions, and texts of reports should be stated in constructive terms. Although findings should be presented in clear, forthright terms, the auditor should keep in mind that his objective is to obtain favorable reaction and that this can best be accomplished by avoiding language which unnecessarily generates defensiveness and opposition. Although criticism of past performance often is necessary to demonstrate the need for some management improvements, the emphasis in reports should be on the needed improvements rather than on criticism.

ISSUES NEEDING FURTHER STUDY

If the scope of the audit or other factors limits the auditor's ability to inquire into certain matters which he believes should be studied, the auditor should include in his report such matters, if of sufficient importance, and the reasons why he believes these matters merit further study.

RECOGNITION OF NOTEWORTHY ACCOMPLISHMENTS

Information as to the satisfactory aspects, not just the deficient aspects, of operations examined, when

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significant and when warranted by the extent of the work, should be included in the auditor's report. Such information is often necessary to fairly present the situation which the auditor finds and to provide appropriate balance to his report. In addition, when such accomplishment may be emulated by others, the inclusion in the auditor's report may result in improved performance by other government organizations that read the report.

VIEWS OF RESPONSIBLE OFFICIALS

One of the most effective ways of ensuring that reports are fair, complete, and objective is through advance reviews and comments by persons or by officials of the organizations, programs, functions, or activities whose operations are discussed in the reports. This produces a report which shows not only what was found and what the auditor thinks about it but also what the responsible persons think about it and what, if anything, they are going to do about it. This kind of report is more useful to the recipient

Comments on report drafts should be objectively considered and evaluated, and the report presentations and conclusions should give appropriate recognition to them. The advance comments and analyses of them should be fairly presented in the text of reports. An agency promise of corrective action should be noted in proper context but should not be accepted as justification for dropping a significant point or a related recommendation.

When the advance comments oppose the auditor's findings or conclusions and are not, in his opinion, meritorious, the auditor should state his reasons for rejecting them. Conversely, he should drop a point or modify a position if he finds the argumentation to be meritorious.

SCOPE AND OBJECTIVES

The scope of the audit should be stated in all reports. Some audits are more limited in scope than others, e.g., those confined to specific functions, activities, or locations. Such limitations of scope should be clearly and explicitly identified. When successive audits vary in scope, the auditor should explain why particular work was or was not performed and also should use individually tailored language in the scope section of the report to

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define the limited nature or special aspects considered in performing the audit. The time period covered in the audit should be indicated.

The scope of the audit should clearly indicate whether each of the three elements of audit examinations--financial and compliance, efficiency and economy, and program results--were made and the extent of each element.

The audit report should include a summary statement of the objectives of the audit as identified in the audit guide or engagement memorandum. This statement is essential to provide the reader with the proper perspective, i.e., a background against which any reported findings may be considered. Management may request special coverage; this too should be provided in the audit instructions.

PRIVILEGED AND CONFIDENTIAL INFORMATION

Certain financial or operating information is prohibited from general disclosure by management or by Federal, State, or local laws or regulations. Such information is usually provided only to persons authorized by law or regulation on a need-to-know basis.

If the auditor is prohibited by such requirements from including some pertinent data in his report, he should describe what has been omitted and the requirement that makes the omission necessary. The auditor should obtain assurance that a valid requirement for the omission exists and that the doctrine of privilege or confidentiality is not applied to information that would reflect unfavorably on management but for which there is no valid reason for withholding.

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CHAPTER 4

FINANCIAL REPORTS

The fourth reporting standard for governmental auditing is:

> Each audit report containing financial reports shall:
>
> 1. Contain an expression of the auditor's opinion on whether the information contained in the financial reports is presented fairly. If the auditor cannot express an opinion, the reasons therefor should be stated in the audit report.
>
> 2. State whether the financial reports have been prepared in accordance with generally accepted or prescribed accounting principles applicable to the organization, program, function, or activity audited and on a consistent basis from one period to the next. Material changes in accounting policies and procedures and their effect on the financial reports are to be explained in the audit report.
>
> 3. Contain appropriate supplementary explanatory information about the contents of the financial reports as may be necessary for full and informative disclosure about the financial operations of the organization, program, function, or activity audited. Violations of legal or other regulatory requirements, including instances of noncompliance, shall be explained in the audit report.

This standard places upon the auditor the responsibility for informing the reader on the degree of responsibility the auditor assumes for the financial data presented in his report and for providing appropriate explanatory comments on

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significant financial issues affecting the reports and compliance with legal or other regulatory requirements.

OPINIONS ON FINANCIAL REPORTS

When financial reports of Federal departments, States, cities, counties, and other units of government and their programs, functions, or activities are being examined, the auditor should give his opinion as to whether the reports have been prepared in accordance with appropriate principles of accounting, applied on a basis consistent with that of the preceding period, and whether the auditor's examination was made in accordance with the accompanying auditing standards. Illustrative opinions are included in Federal audit guides and in pronouncements of the American Institute of Certified Public Accountants.[1] When conformity with special accounting principles is required instead of with generally accepted accounting principles, the special accounting principles followed by the audited organization, program, function, or activity should be specified in the opinion.

ACCOUNTING PRINCIPLES

Accounting principles are guides or rules developed from experience or from research. Their purpose is to provide assurance that the information presented in the financial statements is valid, useful, and reliable. The auditor should make sufficient examination into the accounting principles used to permit a professional opinion as to whether the accounting system and the representations of management evidenced by financial reports are in conformity with such principles. Material changes and the reasons for them, if ascertainable, should be identified and their effect upon the financial reports, both historically and prospectively, should be explained. The auditor should also state his opinion as to the propriety of the change. Accounting principles on which the auditor's opinion is based should be identified in his report, as should statutory or administrative provisions adversely affecting the accounting principles in use by the organization, program, or activity.

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[1] See "Statements on Auditing Procedure," particularly Statement 33.

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CONSISTENCY

The auditor should state whether the entity under audit has consistently followed the same accounting principles from one reporting period to another. This standard applies not only to data shown in statements of financial condition and operating reports but also to budgetary or statistical data which may be covered by the auditor's report.

When a qualification is required because of a lack of consistency that is material to the financial report, the qualification statement should describe (1) the reasons for the qualification, (2) the effect upon the financial reports of the audited entity, and (3) the auditor's opinion of the acceptability of the change.

DISCLOSURE

A governmental entity's reports and statements, both financial and operational, ideally should contain the information necessary for users--management, the electorate, creditors, grantors, and others--to form an opinion on the effectiveness of the stewardship exercised by the responsible public officials. The responsibility for providing such information is that of management. However, the auditor should comment if the data provided is insufficient to disclose any matters which may have a material effect upon the financial reports.

Adequate disclosure does not imply or require that an excessive amount of information be furnished. Disclosure should, however, be fair and reasonably complete--but not so complex as to confuse or impede understanding. Information should be reduced to manageable and understandable proportions, yet it should avoid summarization to such an extent that needed background or relationships are omitted or blurred.

Weight should be given to materiality, which is the relative importance or relevance of an item included in or

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omitted from a financial or operating report. There are no universal ratios or percentages that can be used as standards of materiality for financial or operational processes or transactions. Materiality should be based on judgment.

Six specific indicators of materiality which can be used individually or in combinations are:

1. Absolute dollar amount.

2. Ratio of amount of an item to an appropriate base figure.

3. Length of life of an asset.

4. Importance of the item to the accomplishment of the mission.

5. Importance to the maintenance of adequate controls, such as a pattern of small discrepancies.

6. The characteristic of the items involved, such as indications of malfeasance or misfeasance.

Events that occur subsequent to the end of the period under audit may have a material effect on the operations of the entity or on its operational or financial reports. Such events may affect financial reports directly, may affect the entity with indirect effects on financial reports, or may affect conditions under which the operations take place. If such events occur they should be disclosed in the audit report either by revision of the financial reports or by commentary in the auditor's report.

LEGAL OR REGULATORY REQUIREMENTS

In any governmental audit in which the auditor is expected to give an opinion on the fairness of the presentations in financial reports, compliance with applicable laws and regulatory requirements is a matter of importance because noncompliance might result in liabilities not disclosed in the financial reports. Compliance with laws and regulatory requirements, in many instances, assumes an even greater importance since the recipients of the financial reports and the audit reports also want to know whether funds designated for certain purposes were spent for those purposes.

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The standards for examination and evaluation require consideration of applicable laws and regulations in the auditor's examination. The standards for reporting require a statement in his report regarding any significant instances of noncompliance disclosed by his examination and evaluation work. What is to be included in this statement requires judgment. Significant instances of noncompliance, even those not resulting in legal liability to the audited entity, should be included. Minor procedural noncompliance need not be disclosed.

Although the reporting standard is generally on an exception basis--that only noncompliance need be reported--it should be recognized that governmental entities often want positive statements regarding whether or not the auditor's tests disclosed instances of noncompliance. This is particularly true in grant programs where authorizing agencies frequently want assurance in the auditor's report that this matter has been considered. For such audits auditors should obtain an understanding with the authorizing agency as to the extent to which such positive comments on compliance are desired. When coordinated audits are involved, the audit program should specify the extent of comments that the auditor is to make regarding compliance.

When noncompliance is reported, the auditor should place his findings in proper perspective. The extent of instances of noncompliance should be related to the number of cases examined to provide the reader with a basis for judging the prevalence of noncompliance.

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APPENDIX I

QUALIFICATIONS OF INDEPENDENT AUDITORS

ENGAGED BY GOVERNMENTAL ORGANIZATIONS

When outside auditors are employed for assignments requiring the expression of an opinion on financial reports of governmental organizations, only fully qualified public accountants should be employed. The type of qualifications, as stated by the Comptroller General, deemed necessary for financial audits of governmental organizations and programs is quoted below:

> "Such audits shall be conducted *** by independent certified public accountants or by independent licensed public accountants, licensed on or before December 31, 1970, who are certified or licensed by a regulatory authority of a State or other political subdivision of the United States: Except that independent public accountants licensed to practice by such regulatory authority after December 31, 1970, and persons who although not so certified or licensed, meet, in the opinion of the Secretary, standards of education and experience representative of the highest prescribed by the licensing authorities of the several States which provide for the continuing licensing of public accountants and which are prescribed by the Secretary in appropriate regulations may perform such audits until December 31, 1975; provided, that if the Secretary deems it necessary in the public interest, he may prescribe by regulation higher standards than those required for the practice of public accountancy by the regulatory authorities of the States."[1]

[1] Letter (B-148114, Sept. 15, 1970) from the Comptroller General to heads of Federal departments and agencies. The reference to "Secretary" means the head of the department executing the instrument in which the quotation appears.

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