

Second
Edition

Wiley
**Federal
Government
Auditing**

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

Edward F. Kearney
Roldan Fernandez

Jeffrey W. Green
David M. Zavada

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PREFACE

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PART I

BACKGROUND OF FEDERAL AUDITING

1 BACKGROUND OF FEDERAL AUDITING

Evolution, Standard Setters, Responsibilities, Audit Types

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

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

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

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

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

² *Financial Report of the U.S. Government 2010*, U.S. Department of the Treasury.

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

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

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

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

AUDITING AND GOVERNMENT

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

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

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

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

AUDITING THE FEDERAL GOVERNMENT: DEFINITION AND SCOPE

In the 1970s, the U.S. General Accounting Office⁴ declared that audits of government needed to be more comprehensive and would require, if not entirely different audit standards, then the application of additional standards. These standards would address issues, beyond the financial, important to accountability in the Federal Government and by governments, organizations, entities, and others involved with, or benefiting from, Federal financial assistance. Thus, GAO issued generally accepted auditing standards for government entitled the *Government Auditing Standards* (informally referred to as the Yellow Book). The Yellow Book defined an *audit* as:

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

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

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

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

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

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

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

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

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

FEDERAL AUDITING: WHO SETS THE STANDARDS?

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

American Institute of Certified Public Accountants

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

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

U.S. Government Accountability Office

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

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

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

U.S. Office of Management and Budget

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

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

OMB Circulars and Bulletins

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

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

Offices of Federal Inspectors General

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

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

TYPES OF GOVERNMENTAL AUDITS

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

EXHIBIT 1.1 Types of Audit and Attest Engagements

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

GAGAS: generally accepted government auditing standards

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

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

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

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

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

Financial Audits

Financial Statement Audits

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

Other Financial Audits, Reviews, and Examinations

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

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

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

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

Other chapters of the Yellow Book relate to:

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

Performance Audits

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

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

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

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

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

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

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

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

Other Attest Engagements

Settlement Audits

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

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

Financial-Related Audits

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

⁷ Holmes, Kistler, and Corsini, *Three Centuries of Accounting in Massachusetts*.

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

Financial-related audits have several common features:

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

ORGANIZATION OF THE BOOK

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

Part I: Background of Federal Auditing

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

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

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

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

Part II: Federal Budgeting, Accounting, and Financial Statements

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

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

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

Part III: Auditing in the Federal Government

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

Chapter 6 describes major developments in auditing standards.

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

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

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

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

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

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

Part IV: Nature of Selected Federal Audits

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

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

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

Chapter 15 describes grant and contract audits.

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

2 FEDERAL AUDIT CRITERIA

Laws, Regulations, Audit Standards

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

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

Major Legislation to Establish Federal Financial Management Policy

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

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

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

THE CONSTITUTION: "THE POWER OF THE PURSE"

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

Constitutional Financial Authority

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

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

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