United States Government Accountability Office

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By the Comptroller General of the United States

July 2007

Government Auditing Standards

July 2007 Revision

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Accountability * Integrity * Reliability

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Government Auditing Standards

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The July 2007 revision of Government Auditing Standards supersedes the 2003 revision and updates the January 2007 revision. The July 2007 revision represents the complete 2007 revision of Government Auditing Standards, and is the version that should be used by government auditors until further updates and revisions are made. An electronic version of this document can be accessed on GAO's Yellow Book Web page at http://www.gao.gov/govaud/ybk01.htm.

The July 2007 revision of Government Auditing Standards will be effective for financial audits and attestation engagements for periods beginning on or after January 1, 2008, and for performance audits beginning on or after January 1, 2008. Early implementation is permissible and encouraged. For financial audits, certain standards of the Auditing Standards Board (ASB) that affect Government Auditing Standards become effective prior to these dates.

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
AU	AICPA *Codification of Statements on Auditing Standards*
CPA	certified public accountant
CPE	continuing professional education
COSO	Committee of Sponsoring Organizations of the Treadway Commission
GAAP	generally accepted accounting principles
GAGAS	generally accepted government auditing standards
GAO	U.S. Government Accountability Office
IAASB	International Auditing and Assurance Standards Board
IIA	Institute of Internal Auditors
ISA	International Statements on Auditing
ISACA	Information Systems Audit and Control Association
MD&A	management's discussion and analysis
OMB	U.S. Office of Management and Budget
PCAOB	Public Company Accounting Oversight Board
SAS	Statements on Auditing Standards
SSAE	Statements on Standards for Attestation Engagements

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GAO
Accountability * Integrity * Reliability

Comptroller General
of the United States

United States Government Accountability Office
Washington, D.C. 20548

The principles of transparency and accountability for the use of public resources are key to our nation's governing processes. Government officials and recipients of federal moneys are responsible for carrying out public functions efficiently, economically, effectively, ethically, and equitably, while achieving desired program objectives. High-quality auditing is essential for government accountability to the public and transparency regarding linking resources to related program results. Auditing of government programs should provide independent, objective, fact-based, nonpartisan assessments of the stewardship, performance, and cost of government policies, programs, and operations. Government audits also provide key information to stakeholders and the public to maintain accountability; help improve program performance and operations; reduce costs; facilitate decision making; stimulate improvements; and identify current and projected crosscutting issues and trends that affect government programs and the people those programs serve.

The professional standards presented in this document provide a framework for performing high-quality audit work with competence, integrity, objectivity, and independence. I firmly believe that government auditors should lead by example in the areas of transparency, performance, accountability, and quality through the audit process.

Current trends and longer-range fiscal challenges make auditor oversight especially important to help improve government operations and services today and position them for a better tomorrow. Government auditing plays a major role in improving government operations and services, and in the important dialogue on the future of government programs by providing the objective analysis and information needed to make the decisions necessary to help create a better future. GAO will continue its efforts to lead by example in all of these areas.

The July 2007 revision of *Government Auditing Standards* supersedes the 2003 revision and updates the January 2007 revision. This revision contains the January 2007 revision plus updated quality control and peer review sections in chapter 3 which were exposed in January 2007. The July 2007 revision represents the completed 2007 revision of *Government Auditing Standards*, and is the version that should be used by government auditors until further updates and revisions are made. An electronic version of this document can be accessed on the Web at http://www.gao.gov/govaud/ybk01.htm.

This revision contains the following fundamental changes from the 2003 revision that reinforce the principles of transparency and accountability and provide the framework for high-quality government audits that add value.

- Heightened the emphasis on ethical principles as the foundation, discipline, and structure behind the implementation of the standards, including a description of five key ethical principles that should guide the work of those who audit government programs and operations.

- Clarified and streamlined the discussion of the impact of professional services other than audits or attestation engagements (nonaudit services) and their impact on auditor independence.

- Enhanced and clarified the requirements for an audit organization's system of quality control by specifying the elements of quality that an organization's policies and procedures should collectively address.

- Added a requirement that external audit organizations make their most recent peer review reports publicly available.

- Updated the financial auditing standards based on recent developments in financial auditing and internal control, increased transparency surrounding restatements, and significant concerns, uncertainties, or other unusual events that could have a significant impact on the financial condition or operations of a government entity or program.

- Enhanced performance auditing standards that elaborate on the overall framework for high-quality performance auditing, including the concepts of reasonable assurance and its relationship to audit risk, significance, and the levels of evidence used to support audit findings and conclusions.

- Clarified the standards through standardized language to define the auditor's level of responsibility and distinguish between auditor requirements and additional guidance.

- Reinforced the key role of auditing in maintaining accountability and providing information for making improvements in government operations.

This revision of the standards has gone through an extensive deliberative process, including public comments and input from the Comptroller General's Advisory Council on Government Auditing Standards. The Advisory Council generally consists of about 25 experts in financial and performance auditing and reporting drawn from federal, state, and local government; the private sector; and academia. The views of all parties were thoroughly considered in finalizing the standards.

The July 2007 revision of *Government Auditing Standards* will be effective for financial audits and attestation engagements for periods beginning on or after January 1, 2008, and for performance audits beginning on or after January 1, 2008. Early implementation is permissible and encouraged. For financial audits, certain standards of the Auditing Standards Board (ASB) that affect *Government Auditing Standards* become effective prior to these dates. We encourage audit organizations to implement the relevant sections of the 2007 revision for financial audits concurrent with the implementation of the related ASB standards.

I extend special thanks to the members of the Advisory Council for their extensive input and feedback through the entire process of developing and finalizing the standards.

David M. Walker
Comptroller General
of the United States

July 2007

Use and Application of GAGAS

Introduction

1.01 Auditing is essential to government accountability to the public. Audits and attestation engagements provide an independent, objective, nonpartisan assessment of the stewardship, performance, or cost of government policies, programs, or operations, depending upon the type and scope of the audit.

1.02 The concept of accountability for use of public resources and government authority is key to our nation's governing processes. Government officials entrusted with public resources are responsible for carrying out public functions legally, effectively, efficiently, economically, ethically, and equitably.[1] Government managers are responsible for providing reliable, useful, and timely information for accountability of government programs and their operations. (See appendix I paragraph A1.08 for additional information on management's responsibility.) Legislators, government officials, and the public need to know whether (1) government manages public resources and uses its authority properly and in compliance with laws and regulations; (2) government programs are achieving their objectives and desired outcomes; (3) government services are provided effectively, efficiently, economically, ethically, and equitably; and (4) government managers are held accountable for their use of public resources.

Purpose and Applicability of GAGAS

1.03 The professional standards and guidance contained in this document, commonly referred to as generally accepted government auditing standards (GAGAS), provide a framework for conducting high quality

[1]The term "equity" in this context refers to the approaches used by a government, nonprofit, or other organizations that manage or carry out government programs to provide services to the public in a fair manner within the context of the statutory boundaries of the specific government programs.

government audits and attestation engagements with competence, integrity, objectivity, and independence. These standards are for use by auditors[2] of government entities and entities that receive government awards and audit organizations[3] performing GAGAS audits and attestation engagements. GAGAS contain requirements and guidance dealing with ethics, independence, auditors' professional competence and judgment, quality control, the performance of field work, and reporting. Audits and attestation engagements performed under GAGAS provide information used for oversight, accountability, and improvements of government programs and operations. GAGAS contain requirements and guidance to assist auditors in objectively acquiring and evaluating sufficient, appropriate evidence and reporting the results. When auditors perform their work in this manner and comply with GAGAS in reporting the results, their work can lead to improved government management, better decision making and oversight, effective and efficient operations, and accountability for resources and results.

1.04 Laws, regulations, contracts, grant agreements, or policies frequently require audits in accordance with GAGAS. Many auditors and audit organizations also voluntarily choose to perform their work in accordance with GAGAS. The requirements and guidance in this document apply to audits and attestation engagements of government entities, programs, activities, and functions, and of government assistance administered by contractors, nonprofit entities, and other

[2]The term "auditor" throughout this document includes individuals performing work under GAGAS (including audits and attestation engagements) and, therefore, individuals who may have the titles auditor, analyst, evaluator, inspector, or other similar titles.

[3]The term "audit organization" is used throughout the standards to refer to government audit organizations as well as public accounting firms that perform audits using GAGAS.

nongovernmental entities when the use of GAGAS is required or is voluntarily followed.

Use of Terminology to Define Professional Requirements in GAGAS

1.05 GAGAS contain professional requirements together with related guidance in the form of explanatory material.[4] Auditors have a responsibility to consider the entire text of GAGAS in carrying out their work and in understanding and applying the professional requirements in GAGAS.

1.06 Not every paragraph of GAGAS carries a professional requirement that auditors and audit organizations are expected to fulfill. Rather, the professional requirements are identified through use of specific language.

1.07 GAGAS use two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on auditors and audit organizations, as follows:

a. Unconditional requirements: Auditors and audit organizations are required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. GAGAS use the words *must* or *is required* to specify an unconditional requirement.

b. Presumptively mandatory requirements: Auditors and audit organizations are also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the

[4] The terminology used in GAGAS to designate professional requirements and explanatory material is intended to be consistent with the American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standard No. 102, *Defining Professional Requirements in Statements on Auditing Standards.*

presumptively mandatory requirement applies; however, in rare circumstances, auditors and audit organizations may depart from a presumptively mandatory requirement provided they document their justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. GAGAS use the word *should* to specify a presumptively mandatory requirement.

1.08 Explanatory material is defined as the text within GAGAS (including appendix I) other than the requirements defined in paragraph 1.07. Explanatory material uses the words *may, might,* and *could* to describe explanatory information and is provided to

a. provide further explanation and guidance on the professional requirements or

b. identify and describe other procedures or actions relating to auditors' or audit organizations' activities.

1.09 Explanatory material is intended to be descriptive rather than required. This material is intended, for example, to explain the objective of a requirement where it would be useful to do so; explain why particular procedures may be considered or employed under certain circumstances; or provide additional information to consider in exercising professional judgment.

1.10 Explanatory material that identifies and describes other procedures or actions does not impose a professional requirement on the auditor or audit organization to perform the suggested procedures or actions. How and whether to carry out such procedures or actions depends on the exercise of professional judgment consistent with the objective of the standard.

Stating Compliance with GAGAS in the Auditors' Report

1.11 When auditors are required to follow GAGAS or are representing to others that they followed GAGAS, they should follow all applicable GAGAS requirements and should refer to compliance with GAGAS in the auditors' report as set forth in paragraphs 1.12 and 1.13.

1.12 Auditors should include one of the following types of GAGAS compliance statements in reports on GAGAS audits and attestation engagements, as appropriate.[6]

a. Unmodified GAGAS compliance statement: Stating that the auditor performed the audit or attestation engagement in accordance with GAGAS. Auditors should include an unmodified GAGAS compliance statement in the audit report when they have (1) followed all applicable unconditional and presumptively mandatory GAGAS requirements, or (2) have followed all unconditional requirements and documented justification for any departures from applicable presumptively mandatory requirements, and have achieved the objectives of those requirements through other means.

b. Modified GAGAS compliance statement: Stating either that (1) the auditor performed the audit or attestation engagement in accordance with GAGAS, except for specific applicable requirements that were not followed, or (2) because of the significance of the departure(s) from the requirements, the auditor was unable to and did not perform the audit or attestation engagement in accordance with GAGAS. Situations when auditors use modified compliance statements include scope limitations, such as restrictions on access to records, government officials, or other individuals

[6]For financial audits and attestation engagements, AICPA reporting standards provide additional guidance when some or all of the standards are not followed.

needed to conduct the audit. When auditors use a modified GAGAS statement, they should disclose in the report the applicable requirement(s) not followed, the reasons for not following the requirement(s), and how not following the requirements affected, or could have affected, the audit and the assurance provided.

1.13 When auditors do not comply with any applicable requirements, they should (1) assess the significance of the noncompliance to the audit objectives, (2) document the assessment, along with their reasons for not following the requirement, and (3) determine the type of GAGAS compliance statement.[6] The auditors' determination will depend on the significance of the requirements not followed in relation to the audit objectives.

Relationship between GAGAS and Other Professional Standards

1.14 Auditors may use GAGAS in conjunction with professional standards issued by other authoritative bodies. Auditors may also cite the use of other standards in their audit reports, as appropriate. If the auditor is citing compliance with GAGAS and inconsistencies exist between GAGAS and other standards cited, the auditor should use GAGAS as the prevailing standard for conducting the audit and reporting the results.

1.15 The relationship between GAGAS and other professional standards for financial audits and attestation engagements is as follows:

a. The American Institute of Certified Public Accountants (AICPA) has established professional standards that apply to financial audits and attestation

[6]See footnote 35 for applicability of peer review and quality assurance requirements in this assessment.

engagements for nonissuers[7] performed by certified public accountants (CPA). For financial audits, GAGAS incorporate the AICPA field work and reporting standards and the related Statements on Auditing Standards (SAS)[8] unless specifically excluded or modified by GAGAS. For attestation engagements, GAGAS incorporate the AICPA general standard on criteria, and the field work and reporting standards and the related Statements on Standards for Attestation Engagements (SSAE) unless specifically excluded or modified by GAGAS. GAGAS describe ethical principles, and establish independence and other general standards, and additional field work and reporting standards beyond those provided by the AICPA for performing financial audits and attestation engagements.

b. The Public Company Accounting Oversight Board (PCAOB) has established professional standards that apply to financial audits and attestation engagements for issuers. Auditors may use GAGAS in conjunction with the PCAOB standards.

c. The International Auditing and Assurance Standards Board (IAASB) has established professional standards that apply to financial audits and attestation engagements. Auditors may use GAGAS in conjunction

[7]Under the Sarbanes-Oxley Act of 2002 (Public Law 107-204), audits of issuers (generally, publicly traded companies with a reporting obligation under the Securities Exchange Act of 1934) are subject to rules and standards established by the Public Company Accounting Oversight Board. The term "nonissuer" refers to any entity other than an issuer under the Sarbanes-Oxley Act of 2002, such as privately held companies, nonprofit entities, and government entities.

[8]Because GAGAS incorporate the field work and reporting standards of the AICPA for financial audits performed in which U.S. auditing standards are to be followed, auditors are not required to cite compliance with the AICPA standards when citing compliance with GAGAS, although auditors may cite both sets of standards.

with the IAASB standards and the related statements on International Statements on Auditing (ISA).

1.16 For performance audits, auditors may use other professional standards in conjunction with GAGAS, such as the following:

a. *International Standards for the Professional Practice of Internal Auditing*, The Institute of Internal Auditors, Inc.;

b. *Guiding Principles for Evaluators*, American Evaluation Association;

c. *The Program Evaluation Standards*, Joint Committee on Standards for Education Evaluation; and

d. *Standards for Educational and Psychological Testing*, American Psychological Association.

Types of GAGAS Audits and Attestation Engagements

1.17 This section describes the types of audits and attestation engagements that audit organizations may perform under GAGAS. This description is not intended to limit or require the types of audits or attestation engagements that may be performed under GAGAS.

1.18 All audits and attestation engagements begin with objectives, and those objectives determine the type of audit to be performed and the applicable standards to be followed. The types of audits that are covered by GAGAS, as defined by their objectives, are classified in this document as financial audits, attestation engagements, and performance audits.

1.19 In some audits and attestation engagements, the standards applicable to the specific audit objective will be apparent. For example, if the audit objective is to express an opinion on financial statements, the standards for financial audits apply. However, some engagements may have multiple or overlapping objectives. For example, if the objectives are to determine the reliability of performance measures, this work can be done in accordance with either the standards for attestation engagements or for performance audits. In cases in which there is a choice between applicable standards, auditors should evaluate users' needs and the auditors' knowledge, skills, and experience in deciding which standards to follow.

1.20 GAGAS requirements apply to the types of audit and attestation engagements that may be performed under GAGAS as follows:

a. Financial audits: chapters 1 through 5 apply.

b. Attestation engagements: chapters 1 through 3 and 6 apply.

c. Performance audits: chapters 1 through 3 and 7 and 8 apply.

1.21 Appendix I includes supplemental guidance for auditors and the audited entities to assist in the implementation of GAGAS. Appendix I does not establish auditor requirements but instead is intended to facilitate auditor implementation of the standards contained in chapters 1 through 8.

Financial Audits

1.22 Financial audits provide an independent assessment of and reasonable assurance about whether an entity's reported financial condition, results, and use of resources are presented fairly in accordance with recognized criteria. Reporting on financial audits performed in accordance with GAGAS also includes reports on internal control, compliance with laws and regulations, and provisions of contracts and grant agreements as they relate to financial transactions, systems, and processes. Financial audits performed under GAGAS include financial statement audits and other related financial audits:

a. Financial statement audits: The primary purpose of a financial statement audit is to provide reasonable assurance through an opinion (or disclaim an opinion) about whether an entity's financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP),[9] or with a comprehensive basis of accounting other than GAAP.

b. Other types of financial audits: Other types of financial audits under GAGAS provide for different levels of assurance and entail various scopes of work, including: (1) providing special reports, such as for specified elements, accounts, or items of a financial statement;[10](2) reviewing interim financial information;[11] (3) issuing letters for underwriters and certain other requesting parties; (4) reporting on the controls over

[9]The three U.S.-based authoritative bodies for establishing accounting principles and financial reporting standards are the Federal Accounting Standards Advisory Board (federal government), the Governmental Accounting Standards Board (state and local governments), and the Financial Accounting Standards Board (nongovernmental entities).

[10]Special reports are auditors' reports issued in connection with the following: (1) financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles; (2) specified elements, accounts, or items of a financial statement; (3) compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements; (4) financial presentations to comply with contractual agreements or regulatory requirements; or (5) financial information presented in prescribed forms or schedules that require a prescribed form of auditors' report. (See AU Section 623, *Special Reports.*)

[11]See AU Section 722, *Interim Financial Information.*

processing of transactions by service organizations;[12] and (5) auditing compliance with regulations relating to federal award expenditures and other governmental financial assistance in conjunction with or as a by-product of a financial statement audit.

Attestation Engagements

1.23 Attestation engagements can cover a broad range of financial or nonfinancial objectives and may provide different levels of assurance about the subject matter or assertion depending on the users' needs. Attestation engagements result in an examination, a review, or an agreed-upon procedures report on a subject matter or on an assertion about a subject matter that is the responsibility of another party. The three types of attestation engagements are:

a. Examination: Consists of obtaining sufficient, appropriate evidence to express an opinion on whether the subject matter is based on (or in conformity with) the criteria in all material respects or the assertion is presented (or fairly stated), in all material respects, based on the criteria.

b. Review: Consists of sufficient testing to express a conclusion about whether any information came to the auditors' attention on the basis of the work performed that indicates the subject matter is not based on (or not in conformity with) the criteria or the assertion is not presented (or not fairly stated) in all material respects based on the criteria. As stated in the AICPA SSAE, auditors should not perform review-level work for reporting on internal control or compliance with laws and regulations.

[12]A service organization is the entity or a segment of an entity that provides services to a user organization that are part of the user organization's information system. A user organization is an entity that has engaged a service organization. (See AU Section 324, *Service Organizations*.)

c. Agreed-Upon Procedures: Consists of specific procedures performed on a subject matter.

1.24 The subject matter of an attestation engagement may take many forms. Possible subjects of attestation engagements include reporting on

a. prospective financial or performance information;

b. management's discussion and analysis (MD&A) presentation;

c. an entity's internal control over financial reporting;

d. the effectiveness of an entity's internal control over compliance with specified requirements, such as those governing the bidding for, accounting for, and reporting on grants and contracts;

e. an entity's compliance with requirements of specified laws, regulations, policies, contracts, or grants;

f. the accuracy and reliability of reported performance measures;

g. incurred final contract costs are supported with required evidence and in compliance with the contract terms;

h. the allowability and reasonableness of proposed contract amounts that are based on detailed costs;

i. the quantity, condition, or valuation of inventory or assets; and

j. specific procedures performed on a subject matter (agreed-upon procedures).

Performance Audits

1.25 Performance audits are defined as engagements that provide assurance or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria, such as specific requirements, measures, or defined business practices. Performance audits provide objective analysis so that management and those charged with governance and oversight can use the information to improve program[13] performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability. Reporting information without following GAGAS is not a performance audit but a nonaudit service provided by an audit organization.

1.26 Performance audits that comply with GAGAS provide reasonable assurance that the auditors have obtained sufficient, appropriate evidence to support the conclusions reached. Thus, the sufficiency and appropriateness of evidence needed and tests of evidence will vary based on the audit objectives and conclusions.

1.27 A performance audit is a dynamic process that includes consideration of the applicable standards throughout the course of the audit. An ongoing assessment of the objectives, audit risk, audit procedures, and evidence during the course of the audit facilitates the auditors' determination of what to report and the proper context for the audit conclusions, including discussion about the sufficiency and appropriateness of evidence being used as a basis for the audit conclusions. Performance audit conclusions logically flow from all of these elements and provide an assessment of the audit findings and their implications.

[13]The term "program" is used in this document to include government entities, organizations, programs, activities, and functions.

1.28 Performance audit objectives may vary widely and include assessments of program effectiveness, economy, and efficiency; internal control;[14] compliance; and prospective analyses. These overall objectives are not mutually exclusive. Thus, a performance audit may have more than one overall objective. For example, a performance audit with an initial objective of program effectiveness may also involve an underlying objective of evaluating internal controls to determine the reasons for a program's lack of effectiveness or how effectiveness can be improved.

1.29 Program effectiveness and results audit objectives are frequently interrelated with economy and efficiency objectives. Audit objectives that focus on program effectiveness and results typically measure the extent to which a program is achieving its goals and objectives. Audit objectives that focus on economy and efficiency address the costs and resources used to achieve program results. Examples of audit objectives in these categories include

a. assessing the extent to which legislative, regulatory, or organizational goals and objectives are being achieved;

b. assessing the relative ability of alternative approaches to yield better program performance or eliminate factors that inhibit program effectiveness;

[14]In the context of performance audits, the term "internal control" in this document is synonymous with the term management control and covers all aspects of an entity's operations (programmatic, financial, and compliance).

c. analyzing the relative cost-effectiveness of a program or activity;[15]

d. determining whether a program produced intended results or produced results that were not consistent with the program's objectives;

e. determining the current status or condition of program operations or progress in implementing legislative requirements;

f. determining whether a program provides equitable access to or distribution of public resources within the context of statutory parameters;

g. assessing the extent to which programs duplicate, overlap, or conflict with other related programs;

h. evaluating whether the audited entity is following sound procurement practices;

i. assessing the reliability, validity, or relevance of performance measures concerning program effectiveness and results, or economy and efficiency;

j. assessing the reliability, validity, or relevance of financial information related to the performance of a program;

k. determining whether government resources (inputs) are obtained at reasonable costs while meeting timeliness and quality considerations;

[15]These objectives focus on combining cost information with information about outputs or the benefit provided or with outcomes or the results achieved.

l. determining whether appropriate value was obtained based on the cost or amount paid or based on the amount of revenue received;

m. determining whether government services and benefits are accessible to those individuals who have a right to access those services and benefits;

n. determining whether fees assessed cover costs;

o. determining whether and how the program's unit costs can be decreased or its productivity increased; and

p. assessing the reliability, validity, or relevance of budget proposals or budget requests to assist legislatures in the budget process.

1.30 Internal control audit objectives relate to an assessment of the component of an organization's system of internal control that is designed to provide reasonable assurance of achieving effective and efficient operations, reliable financial and performance reporting, or compliance with applicable laws and regulations. Internal control objectives also may be relevant when determining the cause of unsatisfactory program performance. Internal control comprises the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal control includes the processes and procedures for planning, organizing, directing, and controlling program operations, and management's system for measuring, reporting, and monitoring program performance. Examples of audit objectives related to internal control include an assessment of the extent to which internal control provides reasonable assurance about whether

a. organizational missions, goals, and objectives are achieved effectively and efficiently;

b. resources are used in compliance with laws, regulations, or other requirements;

c. resources, including sensitive information accessed or stored outside the organization's physical perimeter, are safeguarded against unauthorized acquisition, use, or disposition;

d. management information, such as performance measures, and public reports are complete, accurate, and consistent to support performance and decision making;

e. the integrity of information from computerized systems is achieved; and

f. contingency planning for information systems provides essential back-up to prevent unwarranted disruption of the activities and functions that the systems support.

1.31 Compliance audit objectives relate to compliance criteria established by laws, regulations, contract provisions, grant agreements, and other requirements[16] that could affect the acquisition, protection, use, and disposition of the entity's resources and the quantity, quality, timeliness, and cost of services the entity produces and delivers. Compliance objectives include determining whether

a. the purpose of the program, the manner in which it is to be conducted, the services delivered, the outcomes, or the population it serves is in compliance with laws, regulations, contract provisions, grant agreements, and other requirements;

[16]Compliance requirements can be either financial or nonfinancial.

b. government services and benefits are distributed or delivered to citizens based on the individual's eligibility to obtain those services and benefits;

c. incurred or proposed costs are in compliance with applicable laws, regulations, and contracts or grant agreements; and

d. revenues received are in compliance with applicable laws, regulations, and contract or grant agreements.

1.32 Prospective analysis audit objectives provide analysis or conclusions, about information that is based on assumptions about events that may occur in the future along with possible actions that the audited entity may take in response to the future events. Examples of objectives pertaining to this work include providing conclusions based on

a. current and projected trends and future potential impact on government programs and services;

b. program or policy alternatives, including forecasting program outcomes under various assumptions;

c. policy or legislative proposals, including advantages, disadvantages, and analysis of stakeholder views;

d. prospective information prepared by management;

e. budgets and forecasts that are based on
(1) assumptions about expected future events and
(2) management's expected reaction to those future events; and

f. management's assumptions on which prospective information is based.

Professional Services Other Than Audits (Nonaudit Services) Provided by Audit Organizations

1.33 GAGAS do not cover professional services other than audits or attestation engagements (nonaudit services). (See paragraphs 3.25 through 3.30 for additional discussion of nonaudit services.) Therefore, auditors must not report that the nonaudit services were conducted in accordance with GAGAS. When performing nonaudit services for an entity for which the audit organization performs a GAGAS audit or attestation engagement, audit organizations should communicate, as appropriate, with requestors and those charged with governance to clarify that the scope of work performed does not constitute an audit under GAGAS.

1.34 Audit organizations that provide nonaudit services must evaluate whether providing nonaudit services creates an independence impairment either in fact or appearance with respect to the entities they audit. (See paragraph 3.02.)

Ethical Principles in Government Auditing

Introduction

2.01 Because auditing is essential to government accountability to the public, the public expects audit organizations and auditors who conduct their work in accordance with generally accepted government auditing standards (GAGAS) to follow ethical principles. Management of the audit organization sets the tone for ethical behavior throughout the organization by maintaining an ethical culture, clearly communicating acceptable behavior and expectations to each employee, and creating an environment that reinforces and encourages ethical behavior throughout all levels of the organization. The ethical tone maintained and demonstrated by management and staff is an essential element of a positive ethical environment for the audit organization.

2.02 The ethical principles presented in this chapter provide the foundation, discipline, and structure as well as the climate which influence the application of GAGAS. Because the information presented in this chapter deals with fundamental principles rather than specific requirements, this chapter does not contain additional requirements.

2.03 Conducting audit work in accordance with ethical principles is a matter of personal and organizational responsibility. Ethical principles apply in preserving auditor independence,[17] taking on only work that the auditor is competent to perform, performing high-quality work, and following the applicable standards cited in the audit report. Integrity and objectivity are maintained when auditors perform their work and make decisions that are consistent with the broader interest of those relying on the auditors' report, including the public.

[17]Independence requirements are discussed in chapter 3.

Ethical Principles

2.04 The ethical principles contained in the following sections provide the overall framework for application of GAGAS, including general standards, field work standards, and reporting standards. Each principle is described, rather than set forth as a series of requirements, so that auditors can consider the facts and circumstances of each situation within the framework of these ethical principles. Other ethical requirements or codes of professional conduct may also be applicable to auditors who conduct audits in accordance with GAGAS.[18]

2.05 The ethical principles that guide the work of auditors who conduct audits in accordance with GAGAS are

a. the public interest;

b. integrity;

c. objectivity;

d. proper use of government information, resources, and position; and

e. professional behavior.

The Public Interest

2.06 The public interest is defined as the collective well-being of the community of people and entities the auditors serve. Observing integrity, objectivity, and independence in discharging their professional

[18]Individual auditors who are members of professional organizations or are licensed or certified professionals may also be subject to ethical requirements of those professional organizations or licensing bodies. Auditors in government entities may also be subject to government ethics laws and regulations.

responsibilities assists auditors in meeting the principle of serving the public interest and honoring the public trust. These principles are fundamental to the responsibilities of auditors and critical in the government environment.

2.07 A distinguishing mark of an auditor is acceptance of responsibility to serve the public interest. This responsibility is critical when auditing in the government environment. GAGAS embody the concept of accountability for public resources, which is fundamental to serving the public interest.

Integrity

2.08 Public confidence in government is maintained and strengthened by auditors' performing their professional responsibilities with integrity. Integrity includes auditors' conducting their work with an attitude that is objective, fact-based, nonpartisan, and nonideological with regard to audited entities and users of the auditors' reports. Within the constraints of applicable confidentiality laws, rules, or policies, communications with the audited entity, those charged with governance, and the individuals contracting for or requesting the audit are expected to be honest, candid, and constructive.

2.09 Making decisions consistent with the public interest of the program or activity under audit is an important part of the principle of integrity. In discharging their professional responsibilities, auditors may encounter conflicting pressures from management of the audited entity, various levels of government, and other likely users. Auditors may also encounter pressures to violate ethical principles to inappropriately achieve personal or organizational gain. In resolving those conflicts and pressures, acting with integrity means that auditors place priority on their responsibilities to the public interest.

Objectivity

2.10 The credibility of auditing in the government sector is based on auditors' objectivity in discharging their professional responsibilities. Objectivity includes being independent in fact and appearance when providing audit and attestation engagements, maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest. Avoiding conflicts that may, in fact or appearance, impair auditors' objectivity in performing the audit or attestation engagement is essential to retaining credibility. Maintaining objectivity includes a continuing assessment of relationships with audited entities and other stakeholders in the context of the auditors' responsibility to the public.[19]

Proper Use of Government Information, Resources, and Position

2.11 Government information, resources, or positions are to be used for official purposes and not inappropriately for the auditor's personal gain or in a manner contrary to law or detrimental to the legitimate interests of the audited entity or the audit organization. This concept includes the proper handling of sensitive or classified information or resources.

2.12 In the government environment, the public's right to the transparency of government information has to be balanced with the proper use of that information. In addition, many government programs are subject to laws and regulations dealing with the disclosure of information. To accomplish this balance, exercising discretion in the use of information acquired in the course of auditors' duties is an important part in achieving this goal. Improperly disclosing any such information to third parties is not an acceptable practice.

[19]The concepts of objectivity and independence are very closely related. Problems with independence or conflicts of interest may impair objectivity. (See independence standards at paragraphs 3.02 through 3.30.)

2.13 As accountability professionals, accountability to the public for the proper use and prudent management of government resources is an essential part of auditors' responsibilities. Protecting and conserving government resources and using them appropriately for authorized activities is an important element in the public's expectations for auditors.

2.14 Misusing the position of an auditor for personal gain violates an auditor's fundamental responsibilities. An auditor's credibility can be damaged by actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an auditor's personal financial interests or those of an immediate or close family member; a general partner; an organization for which the auditor serves as an officer, director, trustee, or employee; or an organization with which the auditor is negotiating concerning future employment. (See paragraphs 3.07 through 3.09 for further discussion of personal impairments to independence.)

Professional Behavior

2.15 High expectations for the auditing profession include compliance with laws and regulations and avoidance of any conduct that might bring discredit to auditors' work, including actions that would cause an objective third party with knowledge of the relevant information to conclude that the auditors' work was professionally deficient. Professional behavior includes auditors' putting forth an honest effort in performance of their duties and professional services in accordance with the relevant technical and professional standards.

General Standards

Introduction

3.01 This chapter establishes general standards and provides guidance for performing financial audits, attestation engagements, and performance audits under generally accepted government auditing standards (GAGAS). (See chapter 6 for an additional general standard applicable only to attestation engagements.) These general standards, along with the overarching ethical principles presented in chapter 2, establish a foundation for credibility of auditors' work. These general standards emphasize the independence of the audit organization and its individual auditors; the exercise of professional judgment in the performance of work and the preparation of related reports; the competence of audit staff; audit quality control and assurance; and external peer reviews.

Independence

3.02 In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be free from personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments of independence.

3.03 Auditors and audit organizations must maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and viewed as impartial by objective third parties with knowledge of the relevant information. Auditors should avoid situations that could lead objective third parties with knowledge of the relevant information to conclude that the auditors are not able to maintain independence and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work.

3.04 When evaluating whether independence impairments exist either in fact or appearance with respect to the entities for which audit organizations perform audits or attestation engagements, auditors and audit organizations must take into account the three general classes of impairments to independence—personal, external, and organizational.[20] If one or more of these impairments affects or can be perceived to affect independence, the audit organization (or auditor) should decline to perform the work—except in those situations in which an audit organization in a government entity, because of a legislative requirement or for other reasons, cannot decline to perform the work, in which case the government audit organization must disclose the impairment(s) and modify the GAGAS compliance statement. (See paragraphs 1.12 and 1.13.)

3.05 When auditors use the work of a specialist,[21] auditors should assess the specialist's ability to perform the work and report results impartially as it relates to their relationship with the program or entity under audit. If the specialist's independence is impaired, auditors should not use the work of that specialist.

3.06 If an impairment to independence is identified after the audit report is issued, the audit organization should assess the impact on the audit. If the audit organization concludes that it did not comply with GAGAS, it should determine the impact on the auditors' report and notify entity management, those charged with governance, the requesters, or regulatory agencies that have jurisdiction over the audited entity and persons known to be using the audit report about the independence impairment and

[20]Awareness and compliance with other independence standards and applicable ethics laws and regulations associated with their activities may also be required for auditors performing work in accordance with GAGAS.

[21]Specialists to whom this section applies include, but are not limited to, actuaries, appraisers, attorneys, engineers, environmental consultants, medical professionals, statisticians, and geologists.

the impact on the audit. The audit organization should make such notifications in writing.

Personal Impairments

3.07 Auditors participating on an audit assignment must be free from personal impairments to independence.[22] Personal impairments of auditors result from relationships or beliefs that might cause auditors to limit the extent of the inquiry, limit disclosure, or weaken or slant audit findings in any way. Individual auditors should notify the appropriate officials within their audit organizations if they have any personal impairment to independence. Examples of personal impairments of individual auditors include, but are not limited to, the following:

a. immediate family or close family member[23] who is a director or officer of the audited entity, or, as an employee of the audited entity, is in a position to exert direct and significant influence over the entity or the program under audit;

b. financial interest that is direct, or is significant/material though indirect, in the audited entity or program;[24]

[22]This includes those who review the work or the report, and all others within the audit organization who can directly influence the outcome of the audit. The period covered includes the period covered by the audit and the period in which the audit is being performed and reported.

[23]Immediate family member is a spouse, spouse equivalent, or dependent (whether or not related). A close family member is a parent, sibling, or nondependent child.

[24]Auditors are not precluded from auditing pension plans that they participate in if (1) the auditor has no control over the investment strategy, benefits, or other management issues associated with the pension plan and (2) the auditor belongs to such pension plan as part of his/her employment with the audit organization, provided that the plan is normally offered to all employees in equivalent employment positions.

c. responsibility for managing an entity or making decisions that could affect operations of the entity or program being audited; for example, serving as a director, officer, or other senior position of the entity, activity, or program being audited, or as a member of management in any decision making, supervisory, or ongoing monitoring function for the entity, activity, or program under audit;

d. concurrent or subsequent performance of an audit by the same individual who maintained the official accounting records when such services involved preparing source documents or originating data, in electronic or other form; posting transactions (whether coded by management or not coded); authorizing, executing, or consummating transactions (for example, approving invoices, payrolls, claims, or other payments of the entity or program being audited); maintaining an entity's bank account or otherwise having custody of the audited entity's funds; or otherwise exercising authority on behalf of the entity, or having authority to do so;

e. preconceived ideas toward individuals, groups, organizations, or objectives of a particular program that could bias the audit;

f. biases, including those resulting from political, ideological, or social convictions that result from membership or employment in, or loyalty to, a particular type of policy, group, organization, or level of government; and

g. seeking employment during the conduct of the audit with an audited organization.

3.08 Audit organizations and auditors may encounter many different circumstances or combinations of circumstances that could create a personal impairment. Therefore, it is impossible to identify every situation that could result in a personal impairment. Accordingly, audit organizations should include as part of their quality control system procedures to identify personal impairments and help ensure compliance with GAGAS independence requirements. At a minimum, audit organizations should

a. establish policies and procedures to identify, report, and resolve personal impairments to independence,

b. communicate the audit organization's policies and procedures to all auditors in the organization and promote understanding of the policies and procedures,

c. establish internal policies and procedures to monitor compliance with the audit organization's policies and procedures,

d. establish a disciplinary mechanism to promote compliance with the audit organization's policies and procedures,

e. stress the importance of independence and the expectation that auditors will always act in the public interest, and

f. maintain documentation of the steps taken to identify potential personal independence impairments.

3.09 When the audit organization identifies a personal impairment to independence prior to or during an audit, the audit organization should take action to resolve the impairment in a timely manner. In situations in which the personal impairment is applicable only to an individual auditor or a specialist on a particular audit, the audit organization may be able to eliminate the personal impairment. For example, the audit organization could remove that auditor or specialist from any work on that audit or require the auditor or specialist to eliminate the cause of the personal impairment. If the personal impairment cannot be eliminated, the audit organization should withdraw from the audit. In situations in which auditors employed by government entities cannot withdraw from the audit, they should follow paragraph 3.04.

External Impairments

3.10 Audit organizations must be free from external impairments to independence. Factors external to the audit organization may restrict the work or interfere with auditors' ability to form independent and objective opinions, findings, and conclusions. External impairments to independence occur when auditors are deterred from acting objectively and exercising professional skepticism by pressures, actual or perceived, from management and employees of the audited entity or oversight organizations. For example, under the following conditions, auditors may not have complete freedom to make an independent and objective judgment, thereby adversely affecting the audit:

a. external interference or influence that could improperly limit or modify the scope of an audit or threaten to do so, including exerting pressure to inappropriately reduce the extent of work performed in order to reduce costs or fees;

b. external interference with the selection or application *of audit procedures or in the selection of transactions to* be examined;

c. unreasonable restrictions on the time allowed to complete an audit or issue the report;

d. externally imposed restriction on access to records, government officials, or other individuals needed to conduct the audit;

e. external interference over the assignment, appointment, compensation, and promotion of audit personnel;

f. restrictions on funds or other resources provided to the audit organization that adversely affect the audit organization's ability to carry out its responsibilities;

g. authority to overrule or to inappropriately influence the auditors' judgment as to the appropriate content of the report;

h. threat of replacing the auditors over a disagreement with the contents of an audit report, the auditors' conclusions, or the application of an accounting principle or other criteria; and

i. influences that jeopardize the auditors' continued employment for reasons other than incompetence, misconduct, or the need for audits or attestation engagements.

3.11 Audit organizations should include policies and procedures for identifying and resolving external impairments as part of their quality control system for compliance with GAGAS independence requirements.

Organizational Independence

3.12 The ability of audit organizations in government entities to perform work and report the results objectively can be affected by placement within government, and the structure of the government entity being audited. Whether reporting to third parties externally or to top management within the audited entity internally, audit organizations must be free from organizational impairments to independence with respect to the entities they audit. Impairments to organizational independence result when the audit function is organizationally located within the reporting line of the areas under audit or when the auditor is assigned or takes on responsibilities that affect operations of the area under audit.

Organizational Independence for External Audit Organizations

3.13 External audit organizations can be presumed to be free from organizational impairments to independence when the audit function is organizationally placed outside the reporting line of the entity under audit and the auditor is not responsible for entity operations. Audit organizations in government entities can meet the requirement for organizational independence in a number of ways and may be presumed to be free from organizational impairments to independence from the audited entity if the audit organization is

a. at a level of government other than the one to which the audited entity is assigned (federal, state, or local); for example, federal auditors auditing a state government program; or

b. in a different branch of government within the same level of government as the audited entity; for example, legislative auditors auditing an executive branch program.

3.14 Audit organizations in government entities may also be presumed to be free from organizational impairments if the head of the audit organization meets any of the following criteria:

a. directly elected by voters of the jurisdiction being audited;

b. elected or appointed by a legislative body, subject to removal by a legislative body, and reports the results of audits to and is accountable to a legislative body;

c. appointed by someone other than a legislative body, so long as the appointment is confirmed by a legislative body and removal from the position is subject to oversight or approval by a legislative body,[25] and reports the results of audits to and is accountable to a legislative body; or

d. appointed by, accountable to, reports to, and can only be removed by a statutorily created governing body, the majority of whose members are independently elected or appointed and come from outside the organization being audited.

3.15 In addition to the presumptive criteria in paragraphs 3.13 and 3.14, GAGAS recognize that there may be other organizational structures under which audit organizations in government entities could be considered to be free from organizational impairments and thereby be considered organizationally independent for reporting externally. These structures provide safeguards to prevent the audited entity from interfering with the audit organization's ability to perform the work and report the results impartially. For an external audit organization to be considered free from organizational impairments under a structure different from the ones listed in paragraphs 3.13 and 3.14, the audit organization should have all of the following safeguards. In such situations, the audit organization should document how each of the following safeguards were satisfied and provide the documentation to those performing quality control monitoring and to the external peer reviewers to determine whether all the necessary safeguards have been met.

[25]Legislative bodies may exercise their confirmation powers through a variety of means so long as they are involved in the approval of the individual to head the audit organization. This involvement can be demonstrated by approving the individual after the appointment or by initially selecting or nominating an individual or individuals for appointment by the appropriate authority.

a. statutory protections that prevent the audited entity from abolishing the audit organization;

b. statutory protections that require that if the head of the audit organization is removed from office, the head of the agency report this fact and the reasons for the removal to the legislative body;

c. statutory protections that prevent the audited entity from interfering with the initiation, scope, timing, and completion of any audit;

d. statutory protections that prevent the audited entity from interfering with audit reporting, including the findings and conclusions or the manner, means, or timing of the audit organization's reports;

e. statutory protections that require the audit organization to report to a legislative body or other independent governing body on a recurring basis;

f. statutory protections that give the audit organization sole authority over the selection, retention, advancement, and dismissal of its staff; and

g. statutory access to records and documents related to the agency, program, or function being audited and access to government officials or other individuals as needed to conduct the audit.[26]

Organizational Independence for Internal Audit Functions

3.16 Certain federal, state, or local government entities employ auditors to work for management of the audited entities. These auditors may be subject to administrative direction from persons involved in the entity management process. Such audit organizations are

[26]Statutory authority to issue a subpoena to obtain the needed records is one way to meet the requirement for statutory access to records.

internal audit functions and are encouraged to use the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing* in conjunction with GAGAS. Under GAGAS, a government internal audit function can be presumed to be free from organizational impairments to independence for reporting internally if the head of the audit organization meets all of the following criteria:

a. is accountable to the head or deputy head of the government entity or to those charged with governance;

b. reports the audit results both to the head or deputy head of the government entity and to those charged with governance;

c. is located organizationally outside the staff or line-management function of the unit under audit;

d. has access to those charged with governance; and

e. is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal.

3.17 The internal audit organization should report regularly to those charged with governance.

3.18 When internal audit organizations that are free of organizational impairments perform audits of external parties such as auditing contractors or outside party agreements, and no personal or external impairments exist, they may be considered independent of the audited entities and free to report objectively to the heads or deputy heads of the government entities to which they are assigned, to those charged with governance, and to parties outside the organizations in accordance with applicable law, rule, regulation, or policy.

3.19 The internal audit organization should document the conditions that allow it to be considered free of organizational impairments to independence for internal reporting and provide the documentation to those performing quality control monitoring and to the external peer reviewers to determine whether all the necessary safeguards have been met.

Organizational Independence When Performing Nonaudit Services

3.20 Audit organizations at times may perform other professional services (nonaudit services) that are not performed in accordance with GAGAS. Audit organizations that provide nonaudit services must evaluate whether providing the services creates an independence impairment either in fact or appearance with respect to entities they audit.[27] Based on the facts and circumstances, professional judgment is used in determining whether a nonaudit service would impair an audit organization's independence with respect to entities it audits.

3.21 Audit organizations in government entities generally have broad audit responsibilities and, therefore, should establish policies and procedures for accepting engagements to perform nonaudit services so that independence is not impaired with respect to entities they audit. (See appendix I, paragraphs A3.02 and A3.03 for examples of nonaudit services that are generally specific to audit organizations in government entities that generally do not impair the organizations' independence with respect to the entities it audits and, therefore, do not require compliance with the supplemental safeguards described in paragraph 3.30.)

[27]The Government Accountability Office (GAO) has issued further guidance in the form of questions and answers to assist in implementation of the standards associated with nonaudit services. This guidance, *Government Auditing Standards: Answers to Independence Standard Questions*, GAO-02-870G (Washington, D.C.: June 2002), can be found on GAO's Government Auditing Standards Web page (http://www.gao.gov/govaud/ybk01.htm).

Independent public accountants may provide audit and nonaudit services (commonly referred to as consulting) under contractual commitments to an entity and should determine whether nonaudit services they have provided or are committed to provide have a significant or material effect on the subject matter of the audits.

Overarching Independence Principles

3.22 The following two overarching principles apply to auditor independence when assessing the impact of performing a nonaudit service for an audited program or entity: (1) audit organizations must not provide nonaudit services that involve performing management functions or making management decisions and (2) audit organizations must not audit their own work or provide nonaudit services in situations in which the nonaudit services are significant or material to the subject matter of the audits.[28]

3.23 In considering whether audits performed by the audit organization could be significantly or materially affected by the nonaudit service, audit organizations should evaluate (1) ongoing audits; (2) planned audits; (3) requirements and commitments for providing audits, which includes laws, regulations, rules, contracts, and other agreements; and (4) policies placing responsibilities on the audit organization for providing audit services.

3.24 If requested[29] to perform nonaudit services that would impair the audit organization's ability to meet either or both of the overarching independence

[28]The concepts of significance and materiality include quantitative as well as qualitative measures in relation to the subject matter of the audit.

[29]The requestor of nonaudit services could be the management of the audited entity or a third party such as a legislative oversight body.

principles for certain types of audit work, the audit organization should inform the requestor and the audited entity that performing the nonaudit service would impair the auditors' independence with regard to subsequent audit or attestation engagements.

Types of Nonaudit Services

3.25 Nonaudit services generally fall into one of the following categories (see appendix I, paragraphs A3.02 and A3.03 for examples of nonaudit services that are generally unique to audit organizations in government entities):

a. Nonaudit services that do not impair the audit organization's independence with respect to the entities it audits and, therefore, do not require compliance with the supplemental safeguards in paragraph 3.30. (See paragraphs 3.26 and 3.27.)

b. Nonaudit services that would not impair the audit organization's independence with respect to the entities it audits as long as the audit organization complies with the supplemental safeguards in paragraph 3.30. (See paragraph 3.28.)

c. Nonaudit services that do impair the audit organization's independence. Compliance with the supplemental safeguards will not overcome this impairment. (See paragraph 3.29.)

Nonaudit Services That Do Not Impair Auditor Independence

3.26 Nonaudit services in which auditors provide technical advice based on their technical knowledge and expertise do not impair auditor independence with respect to entities they audit and do not require the audit organization to apply the supplemental safeguards.

However, auditor independence would be impaired if the extent or nature of the advice resulted in the auditors' making management decisions or performing management functions.

3.27 Examples of the types of services considered as providing technical advice include the following:

a. participating in activities such as commissions, committees, task forces, panels, and focus groups as an expert in a purely advisory, nonvoting capacity to

(1) advise entity management on issues based on the auditors' knowledge or

(2) address urgent problems;

b. providing tools and methodologies, such as guidance and good business practices, benchmarking studies, and internal control assessment methodologies that can be used by management; and

c. providing targeted and limited technical advice to the audited entity and management to assist them in activities such as (1) answering technical questions or providing training, (2) implementing audit recommendations, (3) implementing internal controls, and (4) providing information on good business practices.

Nonaudit Services That Would Not Impair Independence if Supplemental Safeguards Are Implemented

3.28 Services that do not impair the audit organization's independence with respect to the entities they audit so long as they comply with supplemental safeguards include the following:

a. providing basic accounting assistance limited to services such as preparing draft financial statements that are based on management's chart of accounts and trial balance and any adjusting, correcting, and closing entries that have been approved by management; preparing draft notes to the financial statements based on information determined and approved by management; preparing a trial balance based on management's chart of accounts; maintaining depreciation schedules for which management has determined the method of depreciation, rate of depreciation, and salvage value of the asset (If the audit organization has prepared draft financial statements and notes and performed the financial statement audit, the auditor should obtain documentation from management in which management acknowledges the audit organization's role in preparing the financial statements and related notes and management's review, approval, and responsibility for the financial statements and related notes in the management representation letter. The management representation letter that is obtained as part of the audit may be used for this type of documentation.);

b. providing payroll services when payroll is not material to the subject matter of the audit or to the audit objectives. Such services are limited to using records and data that have been approved by entity management;

c. providing appraisal or valuation services limited to services such as reviewing the work of the entity or a specialist employed by the entity where the entity or specialist provides the primary evidence for the balances recorded in financial statements or other information that will be audited; valuing an entity's pension, other post-employment benefits, or similar liabilities provided management has determined and taken responsibility for all significant assumptions and data;

d. preparing an entity's indirect cost proposal[30] or cost allocation plan provided that the amounts are not material to the financial statements and management assumes responsibility for all significant assumptions and data;

e. providing advisory services on information technology limited to services such as advising on system design, system installation, and system security if management, in addition to the safeguards in paragraph 3.30, acknowledges responsibility for the design, installation, and internal control over the entity's system and does not rely on the auditors' work as the primary basis for determining (1) whether to implement a new system, (2) the adequacy of the new system design, (3) the adequacy of major design changes to an existing system, and (4) the adequacy of the system to comply with regulatory or other requirements;

f. providing human resource services to assist management in its evaluation of potential candidates when the services are limited to activities such as serving on an evaluation panel of at least three individuals to review applications or interviewing candidates to provide input to management in arriving at a listing of best qualified applicants to be provided to management; and

g. preparing routine tax filings based on information provided by the audited entity.

[30]The Office of Management and Budget (OMB) prohibits an auditor who prepared the entity's indirect cost proposal from conducting the required audit when indirect costs recovered by the entity during the prior year exceeded $1 million under OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, Subpart C.305(b), revised June 27, 2003.

Nonaudit Services That Impair Independence

3.29 Compliance with supplemental safeguards will not overcome independence impairments in this category. By their nature, certain nonaudit services directly support the entity's operations and impair the audit organization's ability to meet either or both of the overarching independence principles in paragraph 3.22 for certain types of audit work. Examples of the types of services under this category include the following:

a. maintaining or preparing the audited entity's basic accounting records or maintaining or taking responsibility for basic financial or other records that the audit organization will audit;

b. posting transactions (whether coded or not coded) to the entity's financial records or to other records that subsequently provide input to the entity's financial records;

c. determining account balances or determining capitalization criteria;

d. designing, developing, installing, or operating the entity's accounting system or other information systems that are material or significant to the subject matter of the audit;

e. providing payroll services that (1) are material to the subject matter of the audit or the audit objectives, and/or (2) involve making management decisions;

f. providing appraisal or valuation services that exceed the scope described in paragraph 3.28 c;

g. recommending a single individual for a specific position that is key to the entity or program under audit, otherwise ranking or influencing management's selection of the candidate, or conducting an executive search or a recruiting program for the audited entity;

h. developing an entity's performance measurement system when that system is material or significant to the subject matter of the audit;

i. developing an entity's policies, procedures, and internal controls;

j. performing management's assessment of internal controls when those controls are significant to the subject matter of the audit;

k. providing services that are intended to be used as management's primary basis for making decisions that are significant to the subject matter under audit;

l. carrying out internal audit functions, when performed by external auditors; and

m. serving as voting members of an entity's management committee or board of directors, making policy decisions that affect future direction and operation of an entity's programs, supervising entity employees, developing programmatic policy, authorizing an entity's transactions, or maintaining custody of an entity's assets.[31]

Supplemental Safeguards for Maintaining Auditor Independence When Performing Nonaudit Services

3.30 Performing nonaudit services described in paragraph 3.28 will not impair independence if the

[31]Entity assets are intended to include all of the entity's property including bank accounts, investment accounts, inventories, equipment, or other assets owned, leased, or otherwise in the entity's possession, and financial records, both paper and electronic.

overarching independence principles stated in paragraph 3.22 are not violated. For these nonaudit services, the audit organization should comply with each of the following safeguards:

a. document its consideration of the nonaudit services, including its conclusions about the impact on independence;

b. establish in writing an understanding with the audited entity regarding the objectives, scope of work, and product or deliverables of the nonaudit service; and management's responsibility for (1) the subject matter of the nonaudit services, (2) the substantive outcomes of the work, and (3) making any decisions that involve management functions related to the nonaudit service and accepting full responsibility for such decisions;

c. exclude personnel who provided the nonaudit services from planning, conducting, or reviewing audit work in the subject matter of the nonaudit service;[32] and

d. do not reduce the scope and extent of the audit work below the level that would be appropriate if the nonaudit service were performed by an unrelated party.

Professional Judgment

3.31 Auditors must use professional judgment in planning and performing audits and attestation engagements and in reporting the results.

3.32 Professional judgment includes exercising reasonable care and professional skepticism. Reasonable care concerns acting diligently in

[32]Personnel who provided the nonaudit service are permitted to convey to the audit team the documentation and knowledge gained about the audited entity and its operations.

accordance with applicable professional standards and ethical principles. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of evidence. Professional skepticism includes a mindset in which auditors assume neither that management is dishonest nor of unquestioned honesty. Believing that management is honest is not a reason to accept less than sufficient, appropriate evidence.

3.33 Using the auditors' professional knowledge, skills, and experience to diligently perform, in good faith and with integrity, the gathering of information and the objective evaluation of the sufficiency and appropriateness of evidence is a critical component of audits. Professional judgment and competence are interrelated because judgments made are dependent upon the auditors' competence.

3.34 Professional judgment represents the application of the collective knowledge, skills, and experiences of all the personnel involved with an assignment, as well as the professional judgment of individual auditors. In addition to personnel directly involved in the audit, professional judgment may involve collaboration with other stakeholders, outside experts, and management in the audit organization.

3.35 Using professional judgment in all aspects of carrying out their professional responsibilities, including following the independence standards, maintaining objectivity and credibility, assigning competent audit staff to the assignment, defining the scope of work, evaluating and reporting the results of the work, and maintaining appropriate quality control over the assignment process is essential to performing and reporting on an audit.

3.36 Using professional judgment is important in determining the required level of understanding of the audit subject matter and related circumstances. This includes consideration about whether the audit team's collective experience, training, knowledge, skills, abilities, and overall understanding are sufficient to assess the risks that the subject matter under audit may contain a significant inaccuracy or could be misinterpreted.

3.37 Considering the risk level of each assignment, including the risk that they may come to an improper conclusion is another important issue. Within the context of audit risk, exercising professional judgment in determining the sufficiency and appropriateness of evidence to be used to support the findings and conclusions based on the audit objectives and any recommendations reported is an integral part of the audit process.

3.38 Auditors should document significant decisions affecting the audit objectives, scope, and methodology; findings; conclusions; and recommendations resulting from professional judgment.

3.39 While this standard places responsibility on each auditor and audit organization to exercise professional judgment in planning and performing an audit or attestation engagement, it does not imply unlimited responsibility, nor does it imply infallibility on the part of either the individual auditor or the audit organization. Absolute assurance is not attainable because of the nature of evidence and the characteristics of fraud. Professional judgment does not mean eliminating all possible limitations or weaknesses associated with a specific audit, but rather identifying, considering, minimizing, mitigating, and explaining them.

Competence

3.40 The staff assigned to perform the audit or attestation engagement must collectively possess adequate professional competence for the tasks required.

3.41 The audit organization's management should assess skill needs to consider whether its workforce has the essential skills that match those necessary to fulfill a particular audit mandate or scope of audits to be performed. Accordingly, audit organizations should have a process for recruitment, hiring, continuous development, assignment, and evaluation of staff to maintain a competent workforce. The nature, extent, and formality of the process will depend on various factors such as the size of the audit organization, its structure, and its work.

3.42 Competence is derived from a blending of education and experience. Competencies are not necessarily measured by years of auditing experience because such a quantitative measurement may not accurately reflect the kinds of experiences gained by an auditor in any given time period. Maintaining competence through a commitment to learning and development throughout an auditor's professional life is an important element for auditors. Competence enables an auditor to make sound professional judgments.

Technical Knowledge and Competence

3.43 The staff assigned to conduct an audit or attestation engagement under GAGAS must collectively possess the technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning work on that assignment. The staff assigned to a GAGAS audit or attestation engagement should collectively possess

a. knowledge of GAGAS applicable to the type of work they are assigned and the education, skills, and experience to apply this knowledge to the work being performed;

b. general knowledge of the environment in which the audited entity operates and the subject matter under review;

c. skills to communicate clearly and effectively, both orally and in writing; and

d. skills appropriate for the work being performed. For example, staff or specialist skills in

(1) statistical sampling if the work involves use of statistical sampling;

(2) information technology if the work involves review of information systems;

(3) engineering if the work involves review of complex engineering data;

(4) specialized audit methodologies or analytical techniques, such as the use of complex survey instruments, actuarial-based estimates, or statistical analysis tests, as applicable; or

(5) specialized knowledge in subject matters, such as scientific, medical, environmental, educational, or any other specialized subject matter, if the work calls for such expertise.

Additional Qualifications for Financial Audits and Attestation Engagements

3.44 Auditors performing financial audits should be knowledgeable in generally accepted accounting principles (GAAP), the American Institute of Certified Public Accountants (AICPA) generally accepted auditing standards for field work and reporting and the related Statements on Auditing Standards (SAS), and the application of these standards. Also, if auditors use GAGAS in conjunction with any other standards, they should be knowledgeable and competent in applying those standards. Auditors engaged to perform financial audits or attestation engagements should be licensed certified public accountants or persons working for a licensed certified public accounting firm or a government auditing organization.[33]

3.45 Similarly, for attestation engagements, GAGAS incorporate the AICPA attestation standards. Auditors should be knowledgeable in the AICPA general attestation standard related to criteria, the AICPA attestation standards for field work and reporting, and the related Statements on Standards for Attestation Engagements (SSAE), and they should be competent in applying these standards and SSAE to the task assigned. Also, if auditors use GAGAS in conjunction with any other standards, they should be knowledgeable and competent in applying those standards.

Continuing Professional Education

3.46 Auditors performing work under GAGAS, including planning, directing, performing field work, or reporting on an audit or attestation engagement under GAGAS, should maintain their professional competence through continuing professional education (CPE). Therefore, each auditor performing work under GAGAS should complete, every 2 years, at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates. For auditors who are involved in any amount of planning, directing, or reporting on GAGAS assignments and those auditors who are not involved in those activities but charge 20

[33] Public accountants licensed on or before December 31, 1970, or persons working for a public accounting firm licensed on or before December 31, 1970, are also considered qualified under this standard.

percent or more of their time annually to GAGAS assignments should also obtain at least an additional 56 hours of CPE (for a total of 80 hours of CPE in every 2- year period) that enhances the auditor's professional proficiency to perform audits or attestation engagements. Auditors required to take the total 80 hours of CPE should complete at least 20 hours of CPE in each year of the 2-year period.

3.47 CPE programs are structured educational activities with learning objectives designed to maintain or enhance participants' knowledge, skills, and abilities in areas applicable to performing audits or attestation engagements. Determining what subjects are appropriate for individual auditors to satisfy both the 80-hour and the 24-hour requirements is a matter of professional judgment to be exercised by auditors in consultation with appropriate officials in their audit organizations. Among the considerations in exercising that judgment are the auditors' experience, the responsibilities they assume in performing GAGAS assignments, and the operating environment of the audited entity.

3.48 Improving their own competencies and meeting CPE requirements are primarily the responsibilities of individual auditors. The audit organization should have quality control procedures to help ensure that auditors meet the continuing education requirements, including documentation of the CPE completed. The Government Accountability Office (GAO) has developed guidance pertaining to CPE requirements to assist auditors and audit organizations in exercising professional judgment in complying with the CPE requirements.[34]

[34]This guidance, *Government Auditing Standards: Guidance on GAGAS Requirements for Continuing Professional Education*, GAO-05-568G (Washington, D.C.: April 2005), can be found on GAO's Government Auditing Standards Web page (http://www.gao.gov/govaud/ybk01.htm).

3.49 External specialists assisting in performing a GAGAS assignment should be qualified and maintain professional competence in their areas of specialization but are not required to meet the GAGAS CPE requirements described. However, auditors who use the work of external specialists should assess the professional qualifications of such specialists and document their findings and conclusions. Internal specialists who are part of the audit organization and perform as a member of the audit team should comply with GAGAS, including the CPE requirements.

Quality Control and Assurance

3.50 Each audit organization performing audits or attestation engagements in accordance with GAGAS must:

a. establish a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and

b. have an external peer review at least once every 3 years.[35]

System of Quality Control

3.51 An audit organization's system of quality control encompasses the audit organization's leadership, emphasis on performing high quality work, and the organization's policies and procedures designed to

[35]An audit organization's noncompliance with the peer review requirements (paragraph 3.50b and 3.55 through 3.60) results in a modified GAGAS compliance statement. The audit organization's compliance (or noncompliance) with the requirements for a system of quality control in paragraphs 3.50a and 3.51 through 3.54 are tested and reported on as part of the peer review process and do not impact the GAGAS compliance statement. (See chapter 1, paragraphs 1.11 through 1.13.)

provide reasonable assurance of complying with professional standards and applicable legal and regulatory requirements.[36] The nature, extent, and formality of an audit organization's quality control system will vary based on the audit organization's circumstances, such as the audit organization's size, number of offices and geographic dispersion, the knowledge and experience of its personnel, the nature and complexity of its audit work, and cost-benefit considerations.

3.52 Each audit organization must document its quality control policies and procedures and communicate those policies and procedures to its personnel. The audit organization should document compliance with its quality control policies and procedures and maintain such documentation for a period of time sufficient to enable those performing monitoring procedures and peer reviews to evaluate the extent of the audit organization's compliance with its quality control policies and procedures. The form and content of such documentation are a matter of professional judgment and will vary based on the audit organization's circumstances.

3.53 An audit organization should include policies and procedures in its system of quality control that collectively address:

a. Leadership responsibilities for quality within the audit organization: Policies and procedures that designate responsibility for quality of audits and attestation engagements performed under GAGAS and

[36]The system of quality control discussed in this section is consistent with the AICPA proposed statement on Quality Control Standards, *A Firm's System of Quality Control*, except that the GAGAS requirements in paragraph 3.54 state that reviews of the work and the report that are performed as part of supervision are not monitoring controls when used alone.

communication of policies and procedures relating to quality. Such policies and communications encourage a culture that recognizes that quality is essential in performing GAGAS audits.

b. Independence, legal, and ethical requirements: Policies and procedures designed to provide reasonable assurance that the audit organization and its personnel maintain independence, and comply with applicable legal and ethical requirements.[37]

c. Initiation,[38] acceptance, and continuance of audit and attestation engagements: Policies and procedures for the initiation, acceptance, and continuance of audit and attestation engagements, designed to provide reasonable assurance that the audit organization will undertake audit engagements only if it can comply with professional standards and ethical principles and is acting within the legal mandate or authority of the audit organization.

d. Human resources: Policies and procedures designed to provide the audit organization with reasonable assurance that it has personnel with the capabilities and competence to perform its audits in accordance with

[37]See paragraphs 3.02 through 3.30 for GAGAS dealing with independence. See chapter 2 for GAGAS ethical principles. Individual auditors who are members of professional organizations or are licensed or certified professionals may also be subject to ethical requirements of those professional organizations or licensing bodies. Auditors in government entities may also be subject to government ethics laws and regulations.

[38]Government audit organizations initiate audit and attestation engagements as a result of (1) the audit organization's discretion, (2) requests from legislative bodies or oversight bodies, and (3) legal mandates. In the case of requests and legal mandates, a government audit organization may be required to do the work. See paragraph 3.04 for requirements where an audit organization in a government entity is not independent and, because of a legislative requirement or for other reasons, cannot decline to perform the work.

professional standards and legal and regulatory requirements.[39]

e. Audit and attestation engagement performance, documentation, and reporting: Policies and procedures designed to provide the audit organization with reasonable assurance that audits and attestation engagements are performed and reports are issued in accordance with professional standards and legal and regulatory requirements. (For financial audits, chapters 1 through 5 apply; for attestation engagements, chapters 1 through 3 and 6 apply; for performance audits, chapters 1 through 3 and 7 and 8 apply.)

f. Monitoring of quality: An ongoing, periodic assessment of work completed on audits and attestation engagements designed to provide management of the audit organization with reasonable assurance that the policies and procedures related to the system of quality control are suitably designed and operating effectively in practice. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of (1) adherence to professional standards and legal and regulatory requirements, (2) whether the quality control system has been appropriately designed, and (3) whether quality control policies and procedures are operating effectively and complied with in practice. Monitoring procedures will vary based on the audit organization's facts and circumstances. The audit organization should perform monitoring procedures that enable it to assess compliance with applicable professional standards and quality control policies and procedures for GAGAS audits. Individuals performing monitoring should collectively have sufficient expertise and authority for this role.

[39]See paragraphs 3.40 through 3.49 for requirements dealing with professional competence.

3.54 The audit organization should analyze and summarize the results of its monitoring procedures at least annually, with identification of any systemic issues needing improvement, along with recommendations for corrective action. (Under GAGAS, reviews of the work and the report that are performed as part of supervision are not monitoring controls when used alone. However, these types of pre-issuance reviews may be used as a part of this analysis and summary.)

External Peer Review

3.55 Audit organizations performing audits and attestation engagements in accordance with GAGAS must have an external peer review performed by reviewers independent of the audit organization being reviewed at least once every 3 years.[40]

3.56 The audit organization should obtain an external peer review sufficient in scope to provide a reasonable basis for determining whether, for the period under review,[41] the reviewed audit organization's system of quality control was suitably designed and whether the audit organization is complying with its quality control system in order to provide the audit organization with reasonable assurance of conforming with applicable professional standards.

3.57 The peer review team should include the following elements in the scope of the peer review:

[40]The external peer review requirement is effective within 3 years from the date an audit organization begins field work on its first assignment in accordance with GAGAS for both financial audit practices and performance audit practices. Generally, the deadlines for peer review reports are established by the entity that administers the peer review program. Extensions of the deadlines for submitting the peer review report exceeding 3 months beyond the due date are granted by the entity that administers the peer review program and GAO.

[41]The period under review generally covers 1 year. Peer review programs and audit organizations may choose a longer period to be covered by the peer review.

a. review of the audit organization's quality control policies and procedures;

b. consideration of the adequacy and results of the audit organization's internal monitoring procedures;

c. review of selected audit and attestation engagement reports and related documentation;

d. review of other documents necessary for assessing compliance with standards, for example, independence documentation, CPE records, and relevant human resource management files; and

e. interviews with a selection of the reviewed audit organization's professional staff at various levels to assess their understanding of and compliance with relevant quality control policies and procedures.

3.58 The peer review team should perform a risk assessment to help determine the number and types of engagements to select. Based on the risk assessment, the team should use one or a combination of the following approaches to selecting individual audits and attestation engagements for review: (1) select GAGAS audits and attestation engagements that provide a reasonable cross-section of the GAGAS assignments performed by the reviewed audit organization or (2) select audits and attestation engagements that provide a reasonable cross-section from all types of work subject to the reviewed audit organization's quality control system, including one or more assignments performed in accordance with GAGAS.[42]

[42]The second approach is generally applicable to audit organizations that perform only a small number of GAGAS audits in relation to other types of audits. In these cases, one or more GAGAS audits may represent more than what would be selected when looking at a cross-section of the audit organization's work as a whole.

3.59 The peer review team should prepare one or more written reports communicating the results of the peer review, including the following:

a. description of the scope of the peer review, including any limitations;

b. an opinion on whether the system of quality control of the reviewed audit organization's audit and/or attestation engagement practices was adequately designed and complied with during the period reviewed to provide the audit organization with reasonable assurance of conforming with applicable professional standards;

c. specification of the professional standards to which the reviewed audit organization is being held;

d. for modified or adverse opinions,[43] a description of reasons for the modification or adverse opinion, along with a detailed description of the findings and recommendations, in the peer review report, to enable the reviewed audit organization to take appropriate actions; and

e. reference to a separate letter of comments, if such a letter is issued.

3.60 The peer review team should meet the following criteria:

[43] A modified opinion is an opinion in which the peer reviewer concludes that except for the effects of deficiencies described in the eport, the system of quality control was adequately designed and complied with during the period. An adverse opinion is a conclusion that the system of quality control was not adequately designed and complied with to provide reasonable assurance of conforming with professional standards.

a. The review team collectively has current knowledge of GAGAS and government auditing.

b. The organization conducting the peer review and individual review team members are independent (as defined in GAGAS) of the audit organization being reviewed, its staff, and the audits and attestation engagements selected for the peer review.

c. The review team collectively has sufficient knowledge of how to perform a peer review. Such knowledge may be obtained from on-the-job training, training courses, or a combination of both. Having personnel on the peer review team with prior experience on a peer review or internal inspection team is desirable.

3.61 An external audit organization[44] should make its most recent peer review report[45] publicly available; for example, by posting the peer review report on an external Web site or to a publicly available file designed for public transparency of peer review results. If neither of these options is available to the audit organization, then it should use the same transparency mechanism it uses to make other information public, and also provide the peer review report to others upon request. Internal audit organizations that report internally to management should provide a copy of the external peer review report to those charged with governance. Government audit organizations should also communicate the overall results and the availability of their external peer review reports to appropriate oversight bodies.

3.62 Information in external peer review reports and letters of comment may be relevant to decisions on

[44]An external audit organization is defined in paragraphs 3.13 through 3.15.

[45]This requirement does not include the letter of comment.

procuring audit or attestation engagements. Therefore, audit organizations seeking to enter into a contract to perform an audit or attestation engagement in accordance with GAGAS should provide the following to the party contracting for such services:

a. the audit organization's most recent peer review report and any letter of comment, and

b. any subsequent peer review reports and letters of comment received during the period of the contract.

3.63 Auditors who are using another audit organization's work should request a copy of the audit organization's latest peer review report and any letter of comment, and the audit organization should provide these documents when requested. (See paragraphs 3.05 and 7.41 through 7.43 for further requirements and guidance on using the work of others.)

Field Work Standards for Financial Audits

Introduction

4.01 This chapter establishes field work standards and provides guidance for financial audits conducted in accordance with generally accepted government auditing standards (GAGAS). This chapter identifies the American Institute of Certified Public Accountants (AICPA) field work standards and prescribes additional standards for financial audits performed in accordance with GAGAS.

a. For financial audits, GAGAS incorporate the AICPA field work and reporting standards and the related statements on auditing standards (SAS) unless specifically excluded or modified by GAGAS.[46]

b. Under AICPA standards and GAGAS, auditors must plan and perform the audit to obtain sufficient appropriate audit evidence so that audit risk will be limited to a low level that is, in their professional judgment, appropriate for expressing an opinion on the financial statements. The high, but not absolute, level of assurance that is intended to be obtained by auditors is expressed in the auditor's report as obtaining reasonable assurance about whether the financial statements are free of material misstatement (whether caused by error or fraud). Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.

4.02 For financial audits performed in accordance with GAGAS, chapters 1 through 5 apply.

[46]To date, the Comptroller General has not excluded any field work standards or SAS.

AICPA Field Work Standards

4.03 The three AICPA generally accepted standards of field work are as follows:[47]

a. The auditor must adequately plan the work and must properly supervise any assistants.

b. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

c. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Additional Government Auditing Standards

4.04 GAGAS establish field work standards for financial audits in addition to the requirements contained in the AICPA standards. Auditors should comply with these additional standards when citing GAGAS in their audit reports. The additional government auditing standards relate to:

a. auditor communication during planning (see paragraphs 4.05 through 4.08);

b. previous audits and attestation engagements (see paragraph 4.09);

c. detecting material misstatements resulting from violations of provisions of contracts or grant

[47] See AU Section 150, *Generally Accepted Auditing Standards*.

agreements, or from abuse (see paragraphs 4.10 through 4.13);

d. developing elements of a finding (see paragraphs 4.14 through 4.18); and

e. audit documentation (see paragraphs 4.19 through 4.24).

Auditor Communication During Planning

4.05 Under AICPA standards and GAGAS, auditors should communicate with the audited entity their understanding of the services to be performed for each engagement and document that understanding through a written communication.[48] GAGAS broaden the parties included in the communication and the items for the auditors to communicate.

4.06 Under GAGAS, when planning the audit, auditors should communicate certain information in writing to management of the audited entity, those charged with governance,[49] and to the individuals contracting for or requesting the audit. When auditors perform the audit pursuant to a law or regulation or they conduct the work for the legislative committee that has oversight of the audited entity, auditors should communicate with the legislative committee. In those situations where there is not a single individual or group that both oversees the strategic direction of the entity and the fulfillment of its accountability obligations or in other situations where the identity of those charged with governance is not clearly evident, auditors should document the process

[48]See AICPA Statement on Auditing Standard No. 108, *Planning and Supervision*.

[49]Those charged with governance are those responsible for overseeing the strategic direction of the entity and the entity's fulfillment of its obligations related to the accountability of the entity. (See appendix I, paragraphs A1.05 through A1.07 for additional information.)

followed and conclusions reached for identifying the appropriate individuals to receive the required auditor communications. Auditors should communicate the following additional information under GAGAS:

a. The nature of planned work and level of assurance to be provided related to internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements.

b. Any potential restriction on the auditors' reports, in order to reduce the risk that the needs or expectations of the parties involved may be misinterpreted.

4.07 Under AICPA standards and GAGAS, tests of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements in a financial statement audit contribute to the evidence supporting the auditors' opinion on the financial statements or other conclusions regarding financial data. However, such tests generally are not sufficient in scope to provide an opinion on the effectiveness of internal control over financial reporting or compliance with laws, regulations, and provisions of contracts or grant agreements. To meet the needs of certain audit report users, laws and regulations sometimes prescribe supplemental testing and reporting on internal control over financial reporting and compliance with laws, regulations, and provisions of contracts and grant agreements.[50]

4.08 If an audit is terminated before it is completed and an audit report is not issued, auditors should document the results of the work to the date of termination and why the audit was terminated. Determining whether and how to communicate the reason for terminating the audit to those charged with governance, appropriate officials of the audited entity, the entity contracting for or requesting the audit, and other appropriate officials will depend on the facts and circumstances and, therefore, is a matter of professional judgment.

Previous Audits and Attestation Engagements

4.09 Auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements. When planning the audit, auditors should ask management of the audited entity to identify previous audits, attestation engagements, and other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented. Auditors should use this information in assessing risk and determining the nature, timing, and extent of current audit work, including determining the extent to which testing the implementation of the

[50]For example, when engaged to perform audits under the Single Audit Act, as amended, for state and local government entities and nonprofit entities that receive federal awards, auditors follow Office of Management and Budget (OMB) Circular No. A-133. The act and circular include specific audit requirements, mainly in the areas of compliance with laws and regulations and internal control over compliance that go beyond the requirements in chapters 4 and 5 of GAGAS. Audits performed pursuant to the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994 and the Accountability of Tax Dollars Act of 2002, also have specific audit requirements prescribed by OMB in the areas of internal control and compliance. In addition, some state and local governments may have additional audit requirements that the auditors would need to follow in planning the audit.

corrective actions is applicable to the current audit objectives.

Detecting Material Misstatements Resulting from Violations of Provisions of Contracts or Grant Agreements or from Abuse

4.10 Auditors should design the audit to provide reasonable assurance of detecting misstatements that result from violations of provisions of contracts or grant agreements and could have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.

4.11 If specific information comes to the auditors' attention that provides evidence concerning the existence of possible violations of provisions of contracts or grant agreements that could have a material indirect effect on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether such violations have occurred. When the auditors conclude that a violation of provisions of contracts or grant agreements has or is likely to have occurred, they should determine the effect on the financial statements as well as the implications for other aspects of the audit.

4.12 Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. Abuse does not necessarily involve fraud, violation of laws, regulations, or provisions of a contract or grant agreement.

4.13 If during the course of the audit, auditors become aware of abuse that could be quantitatively or qualitatively material to the financial statements, auditors should apply audit procedures specifically directed to ascertain the potential effect on the financial statements or other financial data significant to the audit objectives. After performing additional work, auditors may discover that the abuse represents potential fraud or illegal acts. Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse.

Developing Elements of a Finding

4.14 Audit findings may involve deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse. The elements needed for a finding depend entirely on the objectives of the audit. Thus, a finding or set of findings is complete to the extent that the audit objectives are satisfied. When auditors identify deficiencies, auditors should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. The elements of an audit finding are discussed in paragraphs 4.15 through 4.18.

4.15 Criteria: The laws, regulations, contracts, grant agreements, standards, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated. Criteria identify the required or desired state or expectation with respect to the program or operation. Criteria provide a context for evaluating evidence and understanding the findings.

4.16 Condition: Condition is a situation that exists. The condition is determined and documented during the audit.

4.17 Cause: The cause identifies the reason or explanation for the condition or the factor or factors responsible for the difference between the situation that exists (condition) and the required or desired state (criteria), which may also serve as a basis for recommendations for corrective actions. Common factors include poorly designed policies, procedures, or criteria; inconsistent, incomplete, or incorrect implementation; or factors beyond the control of program management. Auditors may assess whether the evidence provides a reasonable and convincing argument for why the stated cause is the key factor or factors contributing to the difference.

4.18 Effect or potential effect: The effect is a clear, logical link to establish the impact or potential impact of the difference between the situation that exists (condition) and the required or desired state (criteria). The effect or potential effect identifies the outcomes or consequences of the condition. When the audit objectives include identifying the actual or potential consequences of a condition that varies (either positively or negatively) from the criteria identified in the audit, "effect" is a measure of those consequences. Effect or potential effect may be used to demonstrate the need for corrective action in response to identified problems or relevant risks.

Audit Documentation

4.19 Under AICPA standards and GAGAS, auditors must prepare audit documentation in connection with each audit in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.[51] Under AICPA standards and GAGAS, auditors should prepare audit documentation

[51]See AU Section 339.03 for the AICPA standard on audit documentation.

that enables an experienced auditor,[52] having no previous connection to the audit, to understand

a. the nature, timing, and extent of auditing procedures performed to comply with GAGAS and other applicable standards and requirements;

b. the results of the audit procedures performed and the audit evidence obtained;

c. the conclusions reached on significant matters; and

d. that the accounting records agree or reconcile with the audited financial statements or other audited information.

4.20 Under GAGAS, auditors also should document, before the audit report is issued, evidence of supervisory review of the work performed that supports findings, conclusions, and recommendations contained in the audit report.

4.21 When auditors do not comply with applicable GAGAS requirements due to law, regulation, scope limitations, restrictions on access to records, or other issues impacting the audit, the auditors should document the departure from the GAGAS requirements and the impact on the audit and on the auditors' conclusions. This applies to departures from both mandatory requirements and presumptively mandatory requirements where alternative procedures performed

[52]An experienced auditor means an individual (whether internal or external to the audit organization) who possesses the competencies and skills that would have enabled him or her to perform the audit. These competencies and skills include an understanding of (1) audit processes, (2) GAGAS and applicable legal and regulatory requirements, (3) the environment in which the entity operates, and (4) auditing and financial reporting issues relevant to the audited entity's environment.

in the circumstances were not sufficient to achieve the objectives of the standard. (See paragraphs 1.12 and 1.13.)

4.22 Audit organizations should establish policies and procedures for the safe custody and retention of audit documentation for a time sufficient to satisfy legal, regulatory, and administrative requirements for record retention. Whether audit documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying information could be compromised if the documentation is altered, added to, or deleted without the auditors' knowledge, or if the documentation is lost or damaged. For audit documentation that is retained electronically, the audit organization should establish information systems controls concerning accessing and updating the audit documentation.

4.23 Underlying GAGAS audits is the premise that audit organizations in federal, state, and local governments and public accounting firms engaged to perform a financial audit in accordance with GAGAS cooperate in auditing programs of common interest so that auditors may use others' work and avoid duplication of efforts. Subject to applicable laws and regulations, auditors should make appropriate individuals, as well as audit documentation, available upon request and in a timely manner to other auditors or reviewers to satisfy these objectives. The use of auditors' work by other auditors may be facilitated by contractual arrangements for GAGAS audits that provide for full and timely access to appropriate individuals, as well as audit documentation.

4.24 Audit organizations should develop policies to deal with requests by outside parties to obtain access to audit documentation, especially when an outside party attempts to obtain information indirectly through the auditor rather than directly from the audited entity. In developing such policies, audit organizations should determine what laws and regulations apply, if any.

Additional Considerations for GAGAS Financial Audits

4.25 Due to the audit objectives and public accountability of GAGAS audits, there may be additional considerations for financial audits completed in accordance with GAGAS. These considerations relate to

a. materiality in GAGAS financial audits (see paragraph 4.26);

b. consideration of fraud and illegal acts (see paragraphs 4.27 and 4.28); and

c. ongoing investigations or legal proceedings (see paragraph 4.29).

Materiality in GAGAS Financial Audits

4.26 Under both AICPA standards and GAGAS, the auditors' responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected.[53] The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important. In performing the audit, matters that, either individually or in the aggregate, could be material to the financial statements are a primary consideration.[54] Additional considerations may apply to GAGAS financial audits of government entities or entities that receive government

[53]See AU Section 110, *Responsibilities and Functions of the Independent Auditor.*

[54]See AICPA Statement on Auditing Standards No. 107, *Audit Risk and Materiality in Conducting an Audit.*

awards. For example, in audits performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.[55]

Consideration of Fraud and Illegal Acts

4.27 Under both the AICPA standards[56] and GAGAS, auditors should plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[57] Recognizing the possibility that a material misstatement due to fraud could be present is important for achieving this objective. However, absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud.

[55]In accordance with AICPA Statement on Auditing Standards No. 107, *Audit Risk and Materiality in Conducting an Audit*, the auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. The Financial Accounting Standards Board defined materiality in its Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

[56]See AU Section 316, *Consideration of Fraud in a Financial Statement Audit*.

[57]Two types of misstatements are relevant to the auditors' consideration of fraud in an audit of financial statements–misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional.

4.28 Under both the AICPA standards[58] and GAGAS, auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from illegal acts that could have a direct and material effect on the financial statements.[59] If specific information comes to the auditors' attention that provides evidence concerning the existence of possible illegal acts[60] that could have a material indirect effect on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. When an illegal act has or is likely to have occurred, auditors should determine the effect on the financial statements as well as the implications for other aspects of the audit.

Ongoing Investigations or Legal Proceedings

4.29 Avoiding interference with investigations or legal proceedings is important in pursuing indications of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse. Laws, regulations, or policies might require auditors to report indications of certain types of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse to law enforcement or investigatory authorities before performing additional audit procedures. When investigations or legal proceedings are initiated or in

[58]See AU Sections 317.02, 317.05, and 316.01 for AICPA standards and guidance related to auditors' responsibilities when a possible illegal act is detected.

[59]Illegal acts are violations of laws or government regulations that have a direct and material effect on the determination of financial statement amounts. For example, applicable laws and regulations may affect the amount of revenue accrued under government contracts. However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

[60]Whether a particular act is, in fact, illegal may have to await final determination by a court of law or other adjudicative body. Disclosing matters that have led auditors to conclude that an illegal act is likely to have occurred is not a final determination of illegality.

process, auditors should evaluate the impact on the current audit. In some cases, it may be appropriate for the auditors to work with investigators and/or legal authorities, or withdraw from or defer further work on the audit engagement or a portion of the engagement to avoid interfering with an investigation.

Reporting Standards for Financial Audits

Introduction

5.01 This chapter establishes reporting standards and provides guidance for financial audits conducted in accordance with generally accepted government auditing standards (GAGAS). For financial audits, GAGAS incorporate the American Institute of Certified Public Accountants (AICPA) field work and reporting standards and the related statements on auditing standards (SAS) unless specifically excluded or modified by GAGAS.[61] This chapter identifies the AICPA reporting standards and prescribes additional standards for financial audits performed in accordance with GAGAS.

5.02 For financial audits performed in accordance with GAGAS, chapters 1 through 5 apply.

AICPA Reporting Standards

5.03 The four AICPA generally accepted standards of reporting[62] are as follows:

a. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).

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

[61]To date, the Comptroller General has not excluded any reporting standards or SAS.

[62]See AU Section 150, *Generally Accepted Auditing Standards*. Under AU Section 150, when an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP, the first standard of reporting is satisfied by stating in the auditor's report that the basis of presentation is a comprehensive basis of accounting other than GAAP and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used.

c. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

d. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking in the auditor's report.

Additional Government Auditing Standards

5.04 GAGAS establish reporting standards for financial audits in addition to the standards contained in the AICPA standards. Auditors should comply with these additional standards when citing GAGAS in their audit reports. The additional government auditing standards relate to

a. reporting auditors' compliance with GAGAS (see paragraphs 5.05 and 5.06);

b. reporting on internal control and compliance with laws, regulations, and provisions of contracts or grant agreements (see paragraphs 5.07 through 5.09);

c. reporting deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse (see paragraphs 5.10 through 5.22);

d. communicating significant matters in the auditors' report (see paragraphs 5.23 through 5.25);

e. reporting on the restatement of previously-issued financial statements (see paragraphs 5.26 through 5.31);

f. reporting views of responsible officials (see paragraphs 5.32 through 5.38);

g. reporting confidential or sensitive information (see paragraphs 5.39 through 5.43); and

h. distributing reports (see paragraph 5.44).

Reporting Auditors' Compliance with GAGAS

5.05 When auditors comply with all applicable GAGAS requirements, they should include a statement in the auditors' report that they performed the audit in accordance with GAGAS. (See paragraphs 1.12 and 1.13 for additional requirements on citing compliance with GAGAS.)

5.06 An audited entity receiving a GAGAS audit report may also request auditors to issue a financial audit report for purposes other than complying with requirements for a GAGAS audit. For example, the audited entity may need audited financial statements to issue bonds or for other financing purposes. GAGAS do not prohibit auditors from issuing a separate report conforming only to AICPA or other standards.

Reporting on Internal Control and Compliance with Laws, Regulations, and Provisions of Contracts or Grant Agreements

5.07 When providing an opinion or a disclaimer on financial statements, auditors must also report on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements.

5.08 Auditors should include either in the same or in separate report(s) a description of the scope of the auditors' testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. If the auditors issue separate reports, they should include a reference to the separate reports in the report on financial statements. Auditors should state in the reports whether the tests they performed provided sufficient, appropriate evidence to support an opinion on the effectiveness of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements. The internal control reporting standard under GAGAS differs from the objective of an examination of internal control in accordance with the AICPA Statement on Standards for Attestation Engagements (SSAE), which is to express an opinion on the design or the design and operating effectiveness of an entity's internal control, as applicable. To form a basis for expressing such an opinion, the auditor must plan and perform the examination to obtain reasonable assurance about whether the entity maintained, in all material respects, effective internal control as of a point in time or for a specified period of time.

5.09 When auditors report separately (including separate reports bound in the same document) on internal control over financial reporting and compliance with laws and regulations and provisions of contracts or grant agreements, they should state in the financial statement audit report that they are issuing those additional reports. They should include a reference to the separate reports[63] and also state that the reports on internal control over financial reporting and compliance with laws and regulations and provisions of contracts or grant agreements are an integral part of a GAGAS audit and important for assessing the results of the audit. If auditors issued or intend to issue a management letter,

[63]This requirement applies to financial statement audits described in paragraph 1.22a. It does not apply to other types of financial audits described in paragraph 1.22b.

they should refer to that management letter in the reports.

Reporting Deficiencies in Internal Control, Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, and Abuse

5.10 For financial audits, including audits of financial statements in which auditors provide an opinion or disclaimer, auditors should report, as applicable to the objectives of the audit, and based upon the audit work performed, (1) significant deficiencies in internal control, identifying those considered to be material weaknesses; (2) all instances of fraud and illegal acts unless inconsequential; and (3) violations of provisions of contracts or grant agreements and abuse that could have a material effect on the financial statements.[64]

Deficiencies in Internal Control

5.11 For all financial audits, auditors should report the following deficiencies in internal control:

a. Significant deficiency: a deficiency in internal control, or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote[65] likelihood that a misstatement of the entity's financial statements that is

[64]If the auditor is performing an audit in accordance with Office of Management and Budget (OMB) Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the thresholds for reporting are defined in the circular. Those reporting thresholds satisfy GAGAS.

[65]The term "more than remote" used in the definitions for significant deficiency and material weakness means "at least reasonably possible." The following definitions apply: (1) Remote—The chance of the future events occurring is slight. (2) Reasonably possible—The chance of the future events or their occurrence is more than remote but less than likely. (3) Probable—The future events are likely to occur.

more than inconsequential[66] will not be prevented or detected.[67]

b. Material weakness: a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

5.12 Assessing the significance of control deficiencies includes qualitative considerations such as public accountability of the audited entity, legal and regulatory requirements, the visibility and sensitivity of the entity or program, the needs of users and concerns of oversight officials, and current and emerging risks and uncertainties facing the government entity or entity that receives government funding. The significance of a deficiency in internal control also is influenced by

a. the likelihood that a deficiency, or combination of deficiencies, could fail to prevent or detect a material misstatement of an account balance or disclosure; and

b. the magnitude of the potential misstatement.

[66]The phrase "more than inconsequential" as used in the definition of significant deficiency describes the magnitude of potential misstatement that could occur as a result of a significant deficiency and serves as a threshold for evaluating whether a control deficiency or combination of control deficiencies is a significant deficiency. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

[67]See appendix I, paragraph A.04 for examples of control deficiencies. AU Section 325, *Communicating Internal Control Related Matters Identified in an Audit*, also provides guidance on evaluating potential control deficiencies and examples.

5.13 Auditors should include all significant deficiencies in the auditors' report on internal control over financial reporting and indicate those that represent material weaknesses. If (1) a significant deficiency is remediated before the auditors' report is issued and (2) the auditors obtain sufficient, appropriate evidence supporting the remediation of the significant deficiency, then the auditors should report the significant deficiency and the fact that it was remediated before the auditors' report was issued.

5.14 Determining whether and how to communicate to officials of the audited entity internal control deficiencies that have an inconsequential effect on the financial statements is a matter of professional judgment. Auditors should document such communications.

Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, and Abuse

5.15 Under AICPA standards and GAGAS, auditors have responsibilities for detecting fraud and illegal acts that have a material effect on the financial statements and determining whether those charged with governance are adequately informed about fraud and illegal acts. GAGAS include additional reporting standards. When auditors conclude, based on sufficient, appropriate evidence, that any of the following either has occurred or is likely to have occurred, they should include in their audit report the relevant information about

a. fraud and illegal acts[63] that have an effect on the financial statements that is more than inconsequential,

b. violations of provisions of contracts or grant agreements that have a material effect on the

[63] Whether a particular act is, in fact, illegal may have to await final determination by a court of law or other adjudicative body. Disclosing matters that have led auditors to conclude that an illegal act is likely to have occurred is not a final determination of illegality.

determination of financial statement amounts or other financial data significant to the audit, and

c. abuse that is material, either quantitatively or qualitatively. (See paragraphs 4.12 and 4.13 for a discussion of abuse.)

5.16 When auditors detect violations of provisions of contracts or grant agreements or abuse that have an effect on the financial statements that is less than material but more than inconsequential, they should communicate those findings in writing to officials of the audited entity. Determining whether and how to communicate to officials of the audited entity fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that is inconsequential is a matter of professional judgment. Auditors should document such communications.

5.17 When fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse either have occurred or are likely to have occurred, auditors may consult with authorities or legal counsel about whether publicly reporting such information would compromise investigative or legal proceedings. Auditors may limit their public reporting to matters that would not compromise those proceedings, and for example, report only on information that is already a part of the public record.

Reporting Findings Directly to Parties Outside the Audited Entity

5.18 Auditors should report known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse directly to parties outside the audited entity in the following two circumstances.[69]

[69]Internal audit organizations do not have a duty to report outside the entity unless required by law, rule, regulation, or policy. (See paragraph 5.44b for reporting standards for internal audit organizations when reporting externally.)

a. When entity management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, auditors should first communicate the failure to report such information to those charged with governance. If the audited entity still does not report this information to the specified external parties as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the information directly to the specified external parties.

b. When entity management fails to take timely and appropriate steps to respond to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that (1) is likely to have a material effect on the financial statements and (2) involves funding received directly or indirectly from a government agency, auditors should first report management's failure to take timely and appropriate steps to those charged with governance. If the audited entity still does not take timely and appropriate steps as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the entity's failure to take timely and appropriate steps directly to the funding agency.

5.19 The reporting in paragraph 5.18 is in addition to any legal requirements to report such information directly to parties outside the audited entity. Auditors should comply with these requirements even if they have resigned or been dismissed from the audit prior to its completion.

5.20 Auditors should obtain sufficient, appropriate evidence, such as confirmation from outside parties, to corroborate assertions by management of the audited entity that it has reported such findings in accordance with laws, regulations, and funding agreements. When auditors are unable to do so, they should report such information directly as discussed in paragraph 5.18.

Presenting Findings in the Auditors' Report

5.21 In presenting findings such as deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse, auditors should develop the elements of the findings to the extent necessary to achieve the audit objectives. Clearly developed audit findings, as discussed in paragraphs 4.14 through 4.18, assist management or oversight officials of the audited entity in understanding the need for taking corrective action. If auditors sufficiently develop the elements of a finding, they may provide recommendations for corrective action.

5.22 Auditors should place their findings in perspective by describing the nature and extent of the issues being reported and the extent of the work performed that resulted in the finding. To give the reader a basis for judging the prevalence and consequences of these findings, auditors should, as applicable, relate the instances identified to the population or the number of cases examined and quantify the results in terms of dollar value or other measures, as appropriate. If the results cannot be projected, auditors should limit their conclusions appropriately.

Communicating Significant Matters in the Auditors' Report

5.23 Under AICPA standards, auditors may emphasize in the auditors' report significant matters regarding the financial statements.[70] Due to the public interest in the operations of government entities and entities that receive or administer government awards, there may be situations in GAGAS audits in which certain types of information would help facilitate the readers'

[70]AU Section 508.19 establishes standards and provides guidance on emphasis of a matter in an auditors' report.

understanding of the financial statements and the auditors' report. These situations may be in addition to the examples presented in AICPA standards.

5.24 Examples of matters that auditors may communicate in a GAGAS audit include the following:

a. Significant concerns or uncertainties about the fiscal sustainability of a government or program or other matters that could have a significant impact on the financial condition or operations of the government entity beyond 1 year of the financial statement date.[71] Such concerns or uncertainties may arise due to revenue or expenditure trends; economic dependency on other governments or entities; the government's current commitments, responsibilities, liabilities, or promises to citizens for future benefits that are not sustainable over the long term; deficit trends; the relationship between the financial information and other key indicators; and other significant risks and uncertainties that raise doubts about the long-term sustainability of current government programs in relation to the resources expected to be available. However, auditors are not responsible for designing audit procedures to detect such concerns or uncertainties, and any judgment about the future is based on information that is available at the time the judgment is made.

b. Unusual or catastrophic events that will likely have a significant ongoing or future impact on the entity's financial condition or operations.

[71]AU Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, establishes standards and provides guidance on auditor responsibilities with regard to an entity's ability to continue as a going concern for a reasonable period of time, not to exceed 1 year beyond the date of the financial statements being audited.

c. Significant uncertainties surrounding projections or estimations in the financial statements.

d. Any other matter that the auditors consider significant for communication to users and oversight bodies in the auditors' report.

5.25 Determining whether to communicate such information in the auditors' report is a matter of professional judgment. The communication may be presented in a separate paragraph or separate section of the auditors' report and may include information that is not disclosed in the financial statements.

Reporting on Restatement of Previously-Issued Financial Statements

5.26 AICPA Professional Standards, AU Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, establish standards and provide guidance for situations when auditors become aware of new information that could have affected their report on previously-issued financial statements.[72] Under AU Section 561, if auditors become aware of new information that might have affected their opinion on previously-issued financial statement(s), then the auditors should advise entity management to determine the potential effect(s) of the new information on the previously-issued financial statement(s) as soon as reasonably possible. Such new information may lead management to conclude that previously-issued financial statements were materially misstated and to restate and reissue the misstated financial statements. In such circumstances, auditors should advise management to make appropriate disclosure of the newly discovered facts and their impact on the financial

[72]AU Section 420, *Consistency of Application of GAAP*, and AU Section 508, *Reports on Audited Financial Statements*, provide guidance on when to reissue auditors' reports on restated financial statements.

statements to those who are likely to rely on the financial statements.[73]

5.27 Under GAGAS, auditors should advise management to make appropriate disclosures when the auditors believe that the following conditions exist: (1) it is likely that previously-issued financial statements are misstated and (2) the misstatement is or reasonably could be material. Under GAGAS, auditors also should perform the following procedures related to restated financial statements:[74]

a. evaluate the timeliness and appropriateness of management's disclosure and actions to determine and correct misstatements in previously-issued financial statements (see paragraph 5.28),

b. report on restated financial statements (see paragraphs 5.29 and 5.30), and

c. report directly to appropriate officials when the audited entity does not take the necessary steps (see paragraph 5.31).

Evaluate the Timeliness and Appropriateness of Management's Disclosure and Actions to Determine and Correct Misstatements in Previously-Issued Financial Statements

5.28 Auditors should evaluate the timeliness and appropriateness of management's disclosure to those who are likely to rely on the financial statements and management's actions to determine and correct misstatements in previously-issued financial statements in accordance with AU Sections 561.06 through 561.08. Under GAGAS, auditors also should evaluate whether management

[73]In GAGAS audits, those likely to rely on the financial statements include, at a minimum, those charged with governance, appropriate oversight bodies, and funding agencies.

[74]These additional GAGAS requirements also apply to other financial information on which auditors opine, such as schedules of expenditures of federal awards.

a. acted in an appropriate time frame after new information was available to (1) determine the financial statement effects of the new information and (2) notify those who are likely to rely on the financial statements;

b. disclosed the nature and extent of the known or likely material misstatements on Web pages where management has published the auditors' report on the previously-issued financial statements; and

c. disclosed the following information in the entity's restated financial statements: (1) the nature and cause(s) of the misstatement(s) that led to the need for restatement, (2) the specific amount(s) of the material misstatement(s), and (3) the related effect(s) on the previously-issued financial statement(s) (e.g., year(s) being restated, specific financial statement(s) affected and line items restated, actions the agency's management took after discovering the misstatement), and (4) the impact on the financial statements as a whole (e.g., change in overall net position, change in the audit opinion) and on key information included in the Management Discussion & Analysis.

Report on Restated Financial Statements

5.29 When management restates financial statements, auditors should perform audit procedures sufficient to reissue or update the auditors' report on the restated financial statements regardless of whether the restated financial statements are separately issued or presented on a comparative basis with those of a subsequent period.[75] Auditors should include the following in an explanatory paragraph in the reissued or updated auditors' report:

[75]AU Section 9561.02 provides guidance on auditor association with subsequently discovered information when the auditor has resigned or been discharged. AU Sections 508.70 through 508.73 discusses reissuing predecessor auditors' reports.

a. a statement disclosing that the previously-issued financial statements have been restated;

b. a statement that (1) the previously-issued auditors' report (identified by report date) is not to be relied on because the previously-issued financial statements were materially misstated and (2) the previously-issued auditors' report is replaced by the auditors' report on the restated financial statements;

c. a reference to the note(s) to the restated financial statements that discusses the restatement; and

d. if applicable, a reference to the report on internal control containing a discussion of any significant internal control deficiency identified by the auditors as having failed to prevent or detect the misstatement and any corrective action taken by management to address the deficiency.

5.30 Management's failure to include appropriate disclosures, as discussed in paragraph 5.28c, in restated financial statements may have implications for the audit. In addition, auditors should include the omitted disclosures in the auditors' report, if practicable.

Report Directly to Appropriate Officials When the Audited Entity Does Not Take the Necessary Steps

5.31 Auditors should notify those charged with governance if entity management (1) does not act in an appropriate time frame after new information was available to determine the financial statement effects of the new information and take the necessary steps to timely inform those who are likely to rely on the financial statements and the related auditors' reports of the situation or (2) does not restate with reasonable timeliness the financial statements under circumstances in which auditors believe they need to be restated. Auditors should inform those charged with governance that the auditors will take steps to prevent further reliance on the auditors' report and advise them to notify oversight bodies and funding agencies that rely on the financial statements. If those charged with governance do not notify appropriate oversight bodies and funding agencies, then the auditors should do so.[76]

Reporting Views of Responsible Officials

5.32 If the auditors' report discloses deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse, auditors should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions.

5.33 Providing a draft report with findings for review and comment by responsible officials of the audited entity and others helps the auditors develop a report that is fair, complete, and objective. Including the views of responsible officials results in a report that presents not only the auditors' findings, conclusions, and recommendations, but also the perspectives of the responsible officials of the audited entity and the corrective actions they plan to take. Obtaining the comments in writing is preferred, but oral comments are acceptable.

5.34 When auditors receive written comments from the responsible officials, they should include in their report a copy of the officials' written comments, or a summary of the comments received. When the responsible officials provide oral comments only, auditors should prepare a summary of the oral comments and provide a copy of the summary to the responsible officials to verify that the comments are accurately stated.

[76]The steps taken will depend on the facts and circumstances, including legal considerations.

5.35 Auditors should also include in the report an evaluation of the comments, as appropriate. In cases in which the audited entity provides technical comments in addition to its written or oral comments on the report, auditors may disclose in the report that such comments were received.

5.36 Obtaining oral comments may be appropriate when, for example, there is a reporting date critical to meeting a user's needs; auditors have worked closely with the responsible officials throughout the conduct of the work and the parties are familiar with the findings and issues addressed in the draft report; or the auditors do not expect major disagreements with findings, conclusions, and recommendations in the draft report, or major controversies with regard to the issues discussed in the draft report.

5.37 When the audited entity's comments are inconsistent or in conflict with findings, conclusions, or recommendations in the draft report, or when planned corrective actions do not adequately address the auditors' recommendations, the auditors should evaluate the validity of the audited entity's comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement. Conversely, the auditors should modify their report as necessary if they find the comments valid and supported with sufficient, appropriate evidence.

5.38 If the audited entity refuses to provide comments or is unable to provide comments within a reasonable period of time, the auditors may issue the report without receiving comments from the audited entity. In such cases, the auditors should indicate in the report that the audited entity did not provide comments.