

United States General Accounting Office

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**GAO**

By the Comptroller General of the  
United States

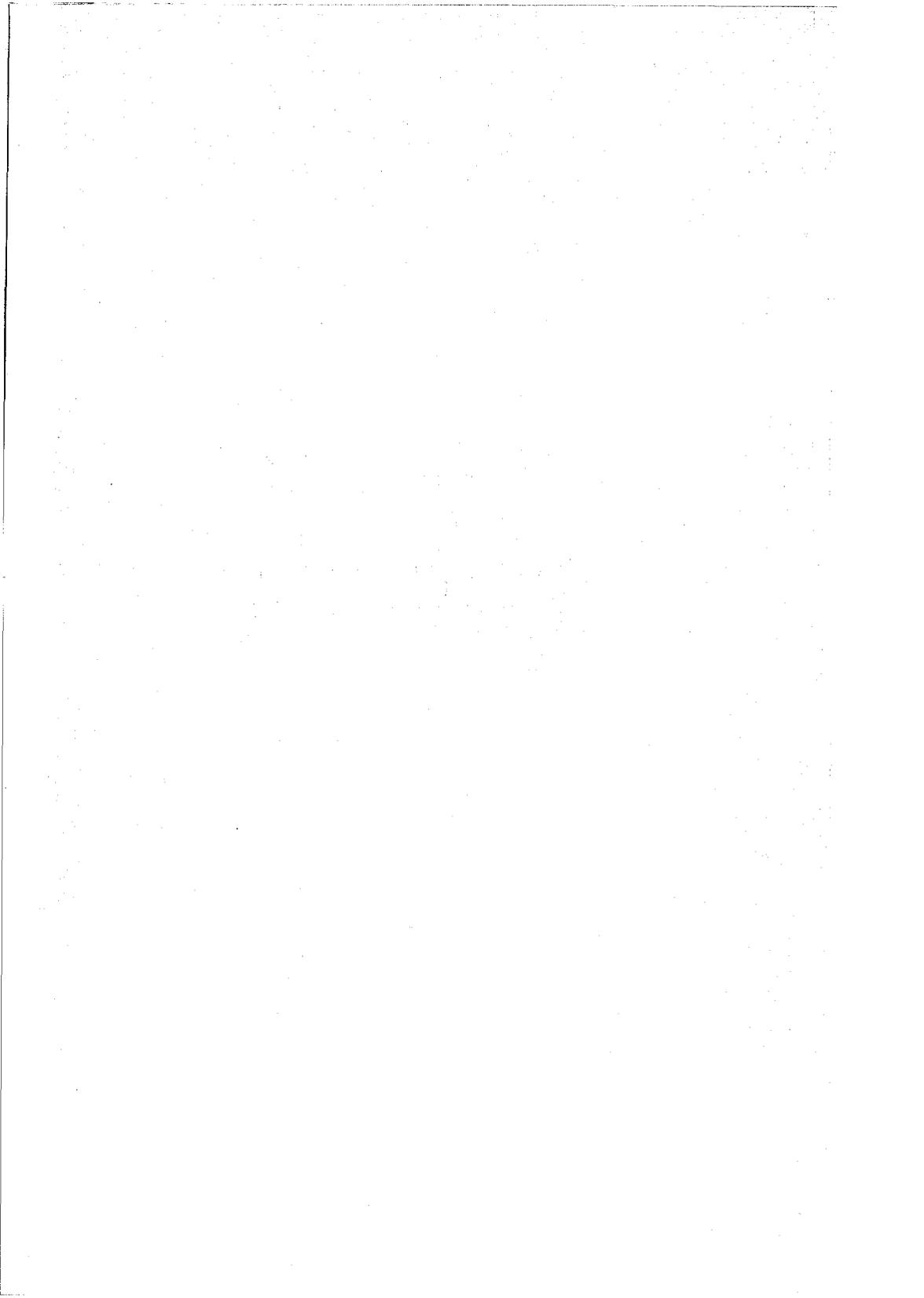
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July 1999

**Government Auditing  
Standards**

**Amendment No. 2**

**Auditor  
Communication**



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**Comptroller General  
of the United States**

This second amendment to *Government Auditing Standards* (1994 revision), Amendment No. 2, *Auditor Communication*, adds a field work standard and amends a reporting standard for financial statement audits to improve auditor communication concerning the auditor's work on compliance with laws and regulations and internal control over financial reporting. This new amendment requires specific communication with the auditee, the individuals contracting for or requesting the audit services, and the audit committee regarding the scope of compliance and internal control work to be performed under *Government Auditing Standards*. The new amendment also requires the auditor to emphasize in the auditor's report on the financial statements the importance of the reports on compliance with laws and regulations and internal control over financial reporting when these reports are issued separately from the report on the financial statements.

The American Institute of Certified Public Accountants (AICPA), in issuing Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees*, and SAS No. 83, *Establishing an Understanding With the Client*, set requirements for auditors to establish an understanding with the client regarding the services to be performed and to determine that certain matters related to the conduct of the audit under generally accepted auditing standards are communicated to those who have responsibility for oversight of the financial reporting process. Amendment No. 2 broadens the parties who the auditor must communicate with and requires the auditor to communicate specific information regarding the nature and extent of testing and reporting on compliance with laws and regulations and internal control over financial reporting during the planning stages of a financial statement audit. The Advisory Council on Government Auditing Standards recommended the issuance of this amendment to reduce the risk that the needs or expectations of the parties involved may be misinterpreted and to highlight the importance of the auditor's reports on compliance with laws and regulations and internal control over financial reporting required under *Government Auditing Standards*.

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This amendment moves a reporting standard on auditor communication, (paragraphs 5.5 through 5.10) in chapter 5, with some modification, to a field work standard (paragraphs 4.6.3 through 4.6.9), as communication on the scope of work to be performed on an audit is viewed more appropriately as a field work standard. In addition, this amendment revises the section entitled "Reporting on Compliance With Laws and Regulations and on Internal Controls" (paragraphs 5.15 through 5.17) in chapter 5.

This amendment includes changes resulting from *Government Auditing Standards: Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems* (GAO/A-GAGAS-1, May 1999). This amendment also includes conforming changes to recognize, where applicable, standards issued by the AICPA subsequent to the issuance of the 1994 revision of *Government Auditing Standards*, and the issuance of Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* issued in June 1997.

This amendment is effective for financial statement audits of periods ending on or after January 1, 2000. Earlier application is permissible.

We have included as appendixes I and II versions of chapters 4 and 5, respectively, which show the deletion of language appearing in *Government Auditing Standards* (1994 revision), as amended by Amendment No. 1, with a strikeout and present the new or amended language with bold and italics. Appendix III contains a list of members to the Comptroller General's Advisory Council on Government Auditing Standards.

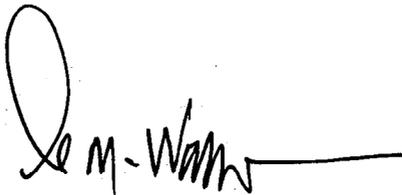
An electronic version of this amendment can be accessed through GAO's Internet Home Page ([www.gao.gov](http://www.gao.gov)) from the GAO Policy and Guidance Materials or the Special Publications sections of the GAO site, or directly at [www.gao.gov/govaud/ybk01.htm](http://www.gao.gov/govaud/ybk01.htm). This site also contains a new electronic version of *Government Auditing Standards*, which codifies the new amendment by

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reflecting changes made resulting from the issuance of recent amendments. Printed copies of this amendment can be obtained from the U. S. Government Printing Office.

This amendment was exposed for public comment prior to its final issuance. As a result, various suggestions were incorporated into the final amendment. I thank those who suggested improvements to the amendment, and I especially commend the Advisory Council on Government Auditing Standards and the project team for their efforts.

If you have any questions regarding this amendment, please contact Robert W. Gramling, Director, Corporate Audits and Standards, Accounting and Information Management Division, (202) 512-9406. Key contributors to this amendment were Cheryl E. Clark, Marcia B. Buchanan, and Michael C. Hrapsky.

A handwritten signature in black ink, appearing to read "D. M. Walker", with a long horizontal line extending to the right.

David M. Walker  
Comptroller General  
of the United States

## Chapter 4

# Field Work Standards for Financial Audits

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This amendment to *Government Auditing Standards* (1994 revision) establishes a new field work standard and revises a reporting standard for financial statement audits to improve auditor communication concerning the auditor's work on compliance with laws and regulations and internal control over financial reporting with users of the auditor's reports. This standard is effective for financial statement audits of periods ending on or after January 1, 2000. Earlier application is permissible.

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### Purpose

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

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### Relation to AICPA Standards

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

- a. The work is to be adequately planned and assistants, if any, are to be properly supervised.
- b. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- c. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

**4.3** The AICPA has issued statements on auditing standards (SAS) that interpret its standards of field

work (including a SAS on compliance auditing).<sup>1</sup> This chapter incorporates these SASs and prescribes additional standards on

- a. auditor communication (see paragraphs 4.6.3 through 4.6.9),
- b. audit follow-up (see paragraphs 4.7, 4.10, and 4.11),
- c. noncompliance other than illegal acts (see paragraphs 4.13 and 4.18 through 4.20),
- d. documentation requirements when assessing control risk at maximum for controls significantly dependent upon computerized information systems (see paragraphs 4.21.1 through 4.21.4), and
- e. working papers. (See paragraphs 4.34 through 4.38.)

**4.4** This chapter also discusses three other key aspects of financial statement audits:

- a. materiality (see paragraphs 4.6.1 and 4.6.2),
- b. fraud and illegal acts (see paragraphs 4.14 through 4.17), and
- c. internal control. (See paragraphs 4.22 and 4.25 through 4.30.)

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

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

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Planning

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

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

**4.6.1** Auditors' consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

**4.6.2** In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.

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Auditor  
Communication

**4.6.3** The first additional planning standard for financial statement audits is

**Auditors should communicate information to the auditee, the individuals contracting for or requesting the audit services, and the audit committee regarding the nature and extent of planned testing and reporting on compliance with laws and regulations and internal control over financial reporting.**

**4.6.4** AICPA standards and GAGAS require auditors to establish an understanding with the client and to communicate with audit committees. GAGAS broaden

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who auditors must communicate with and require auditors to communicate specific information regarding the nature and extent of testing and reporting on compliance with laws and regulations and internal control over financial reporting during the planning stages of a financial statement audit to reduce the risk that the needs or expectations of the parties involved may be misinterpreted.

**4.6.5** The auditee is the organization or entity being audited. Auditors should communicate their responsibilities for the engagement to the appropriate officials of the auditee (which would normally include the head of the organization, the audit committee or board of directors or other equivalent oversight body in the absence of an audit committee, and the individual who possesses a sufficient level of authority and responsibility for the financial reporting process, such as the chief financial officer). In situations where auditors are performing the audit under a contract with a party other than the auditee, or pursuant to a third-party request, auditors should also communicate with the individuals contracting for or requesting the audit, such as contracting officials or legislative members or staff. When auditors are performing the audit pursuant to a law or regulation, auditors should communicate with the legislative members or staff who have oversight of the auditee.<sup>1,1</sup>

**4.6.6** During the planning stages of an audit, auditors should communicate their responsibilities in a financial statement audit, including their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting.

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<sup>1,1</sup>This requirement applies only to situations where the law or regulation specifically identifies the entity to be audited, such as an audit of a specific agency's financial statements required by the Chief Financial Officers Act, as expanded by the Government Management Reform Act of 1994. Situations where the financial statement audit mandate applies to entities not specifically identified, such as audits required by the Single Audit Act Amendments of 1996, are excluded.

Such communication should include the nature of any additional testing of compliance and internal control required by laws and regulations or otherwise requested and whether the auditors are planning on providing opinions on compliance with laws and regulations and internal control over financial reporting.

**4.6.7** Auditors should use their professional judgment to determine the form and content of the communication. Written communication is preferred. Auditors should document the communication in the working papers. Auditors may use an engagement letter to communicate the information described in paragraph 4.6.6. To assist in understanding the limitations of auditors' responsibilities for testing and reporting on compliance and internal control over financial reporting, auditors may want to contrast those responsibilities with other financial related audits of compliance and controls. The discussion in paragraphs 4.6.8 and 4.6.9 may be helpful to auditors in explaining their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting to the auditee and other interested parties.

**4.6.8** Tests of compliance with laws and regulations and internal control over financial reporting in a financial statement audit contribute to the evidence supporting the auditors' opinion on the financial statements. However, they generally do not provide a basis for opining on compliance or internal control over financial reporting. To meet certain audit report users' needs, laws and regulations sometimes prescribe testing and reporting on compliance and internal

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control over financial reporting to supplement the financial statement audit's coverage of these areas.<sup>1,2</sup>

**4.6.9** Even after auditors perform and report the results of additional tests of compliance and internal control over financial reporting required by laws and regulations, some reasonable needs of report users still may be unmet. Auditors may meet these needs by performing further tests of compliance and internal control in either of two ways:

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

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## Audit Follow-up

**4.7** The second additional planning standard for financial statement audits is

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

[Paragraphs 4.8 and 4.9 have been moved and renumbered to paragraphs 4.6.1 and 4.6.2.]

**4.10** Auditors should follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. They should do this to determine whether the auditee has

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<sup>1,2</sup>For example, when engaged to perform audits under the Single Audit Act of state and local government entities and nonprofit organizations that receive federal awards, auditors should be familiar with the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133. The act and circular include specific audit requirements, mainly in the areas of compliance with laws and regulations and internal control, that exceed the minimum audit requirements in the standards in chapters 4 and 5 of this document. Audits conducted under the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, also have specific audit requirements prescribed by OMB in the areas of compliance and internal control. Many state and local governments have additional audit requirements.

taken timely and appropriate corrective actions. Auditors should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statements.

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

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## Fraud, Illegal Acts, and Other Noncompliance

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

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

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

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<sup>2</sup>Two types of misstatements are relevant to the auditors' consideration of fraud in a financial statement audit—misstatements arising from fraudulent financial statements 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.

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

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

**4.13** The additional compliance standard for financial statement audits is

**Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible noncompliance that could have a material indirect effect on the financial statements, auditors should apply audit procedures specifically directed to ascertaining whether that noncompliance has occurred.**

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**Auditors'  
Understanding of  
Possible Fraud and  
of Laws and  
Regulations**

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

**4.15** Auditors should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination

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

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

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**Due Care  
Concerning Possible  
Fraud and Illegal Acts**

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

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

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

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Noncompliance  
Other Than Illegal  
Acts

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

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

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

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Internal Control

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

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

**4.21.1** AICPA standards and GAGAS require that, in all audits, auditors obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand (1) the design of controls relevant to an audit of financial statements and (2) whether the controls have been placed in operation. This understanding should include a consideration of the methods an entity uses to process accounting information because such methods influence the design of internal control. The extent to which computerized information systems are used in significant accounting applications,<sup>5.1</sup> as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in planning the audit and in obtaining an understanding of internal control over an entity's computer processing, auditors should consider, among other things, such matters as

- a. the extent to which computer processing is used in each significant accounting application;<sup>5.2</sup>
- b. the complexity of the entity's computer operations;
- c. the organizational structure of the computer processing activities; and
- d. the kinds and competence of available evidential matter, in electronic and in paper formats, to achieve audit objectives.

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<sup>5.1</sup>Significant accounting applications are those which relate to accounting information that can materially affect the financial statements the auditor is auditing. Significant accounting applications could include financial as well as other systems, such as management information systems or systems that monitor compliance, if they provide data for material account balances, transaction classes, and disclosure components of financial statements.

<sup>5.2</sup>Obtaining an understanding of these elements would include consideration of internal control related to security over computerized information systems.

**4.21.2** AICPA standards and GAGAS require auditors to document their understanding of the components of an entity's internal control related to computer applications that process information used in preparing an entity's financial statements and, based on that understanding, to develop a planned audit approach in sufficient detail to demonstrate its effectiveness in reducing audit risk. In doing so, under AICPA standards and GAGAS, auditors should consider whether specialized skills are needed for considering the effect of computerized information systems on the audit, understanding internal control, or designing and performing audit procedures, including tests of internal control. If the use of a professional with specialized skills is planned, auditors should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditors' objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

**4.21.3** The additional internal control standard for financial statement audits is

**In planning the audit, auditors should document in the working papers (1) the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems and (2) consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.**

**4.21.4** This additional GAGAS standard does not increase the auditors' responsibility for testing controls, but rather requires that, if auditors assess control risk at the maximum level for assertions related to material

account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, auditors should document in the working papers<sup>5.3</sup> the basis for that conclusion by addressing (1) the ineffectiveness of the design and/or operation of the controls, or (2) the reasons why it would be inefficient to test the controls. In such circumstances, GAGAS also require auditors to document in the working papers the consideration that the planned audit procedures are designed to achieve specific audit objectives and, accordingly, to reduce audit risk to an acceptable level. This documentation should address

- a. the rationale for determining the nature, timing, and extent of planned audit procedures;
- b. the kinds and competence of available evidential matter produced outside a computerized information system; and
- c. the effect on the audit opinion or report if evidential matter to be gathered during the audit does not afford a reasonable basis for the auditor's opinion on the financial statements.

**4.22** Safeguarding of assets and compliance with laws and regulations are internal control objectives that are especially important in conducting financial statement audits in accordance with GAGAS of governmental entities or others receiving government funds. Given the public accountability for stewardship of resources, safeguarding of assets permeates control objectives and components as defined by the AICPA standards and GAGAS. Also, the operation of government programs and the related transactions that materially affect the entity's financial statements are generally governed by laws and regulations. Although GAGAS are not

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<sup>5.3</sup>See paragraphs 4.34 through 4.38 for a discussion of the working paper standards.

prescribing additional internal control standards in these areas, this chapter provides a discussion that auditors may find useful in assessing audit risk and in obtaining evidence needed to support their opinion on the financial statements in a governmental environment.

[Paragraphs 4.23 and 4.24 deleted.]

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## Safeguarding of Assets

**4.25** As applied to financial statement audits, internal control over safeguarding of assets constitutes a process, effected by an entity's governing body, management, and other detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

**4.26** Internal control over the safeguarding of assets relates to the prevention or timely detection of unauthorized transactions and unauthorized access to assets that could result in losses that are material to the financial statements; for example, when unauthorized expenditures or investments are made, unauthorized liabilities are incurred, inventory is stolen, or assets are converted to personal use. Such controls are designed to help ensure the use of and access to assets are in accordance with management's authorization. Authorization includes approval of transactions in accordance with control activities established by management to safeguard assets, such as establishing and complying with requirements for extending and monitoring credit or making investment decisions, and related documentation. Control over safeguarding of assets is not designed to protect against loss of assets arising from inefficiency or from management's operating decisions, such as incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory.

**4.27** AICPA standards and GAGAS require auditors to obtain a sufficient understanding of internal control to plan the audit. They also require auditors to plan the audit to provide reasonable assurance of detecting

material fraud, including material misappropriation of assets. Because preventing or detecting material misappropriations is an objective of control over safeguarding of assets, understanding this type of control can be essential to planning the audit.

**4.28** Control over safeguarding of assets is not limited to preventing or detecting misappropriations, however. It also helps prevent or detect other material losses that could result from unauthorized acquisition, use, or disposition of assets. Such controls include, for example, the process of assessing the risk of unauthorized acquisition, use, or disposition of assets and establishing control activities to help ensure that management directives to address the risk are carried out. Such control activities would include permitting acquisition, use, or disposition of assets only in accordance with management's general or specific authorization, including compliance with established control activities for such acquisition, use, or disposition. They would also include comparing existing assets with the related records at reasonable intervals and taking appropriate action with respect to any differences. Finally, controls over safeguarding of assets against unauthorized acquisition, use, or disposition also relate to making available to management information it needs to carry out its responsibilities related to prevention or timely detection of such unauthorized activities, as well as mechanisms to enable management to monitor the continued effective operation of such controls.

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

a. failure to adequately monitor decentralized operations;

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

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Control Over  
Compliance With  
Laws and  
Regulations

**4.29.1** Governmental entities are subject to a variety of laws and regulations that affect their financial statements, which is a major factor distinguishing governmental accounting from commercial accounting. For example, such laws and regulations may address the required fund structure, procurement or debt limitations, or authority for transactions. Accordingly, compliance with such laws and regulations may have a direct and material effect on the determination of amounts in the financial statements of governmental entities. Likewise, organizations that receive government assistance, such as contractors, nonprofit organizations, and other nongovernmental organizations, are also subject to regulations, contract provisions, or grant agreements that could have a direct and material effect on their financial statements. Management, of both governmental entities and others receiving governmental assistance, is responsible for ensuring that the entity complies with the laws and regulations applicable to its activities. That responsibility encompasses the identification of applicable laws and regulations and the establishment of controls designed to provide reasonable assurance that the entity complies with those laws and regulations.

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**4.30** AICPA standards and GAGAS require auditors to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. To meet that requirement, auditors should have an understanding of internal control relevant to financial statement assertions affected by those laws and regulations. Auditors should use that understanding to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. For example, the following factors may influence the auditors' assessment of control risk:

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

[Paragraphs 4.31 through 4.33 deleted.]

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**Working Papers**

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

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

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

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

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

**4.37** Working papers should contain

- a. the objectives, scope, and methodology, including any sampling criteria used;
- b. documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records;<sup>6</sup> and
- c. evidence of supervisory reviews of the work performed.

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

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

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**Financial  
Related Audits**

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

- a. SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specific Elements, Accounts, or Items of a Financial Statement*;
- b. SAS No. 62, *Special Reports*, for auditing specified elements, accounts, or items of a financial statement;
- c. SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, for testing compliance with laws and regulations applicable to federal financial assistance programs;
- d. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, for examining descriptions of internal control of service organizations that process transactions for others;
- e. Statement on Standards for Attestation Engagements (SSAE) No. 1, *Attestation Standards*, as amended by SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for examining or reviewing an entity's assertions about financial related matters not specifically addressed in other AICPA standards;
- f. SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting*, as amended by SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for examining an entity's assertions about its internal control over financial reporting and/or safeguarding assets;

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

**g.** SSAE No. 3, *Compliance Attestation*, as amended by SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for (1) examining or applying agreed-upon procedures to an entity's assertions about compliance with specified requirements or (2) applying agreed-upon procedures to an entity's assertions about internal control over compliance with laws and regulations; and

**h.** SSAE No. 4, *Agreed-Upon Procedures Engagements*, for applying agreed-upon procedures to (1) an entity's assertions about internal control over financial reporting and/or safeguarding of assets or (2) an entity's assertions about financial related matters not specifically addressed in other AICPA standards.

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

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

# Chapter 5

## Reporting Standards for Financial Audits

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### Purpose

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

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### Relation to AICPA Standards

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

- a.** The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
- b.** The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
- c.** Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- d.** The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

**5.3** The AICPA has issued statements on auditing standards (SAS) that interpret its standards of reporting.<sup>1</sup> This chapter incorporates these SASs and prescribes additional standards on

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

a. reporting compliance with GAGAS (see paragraphs 5.11 through 5.14),

b. reporting on compliance with laws and regulations and on internal control over financial reporting (see paragraphs 5.15 through 5.28),

c. privileged and confidential information (see paragraphs 5.29 through 5.31), and

d. report distribution. (See paragraphs 5.32 through 5.35.)

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

[Paragraphs 5.5 through 5.10 and footnote 2 deleted.]

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Reporting  
Compliance With  
Generally  
Accepted  
Government  
Auditing  
Standards

5.11 The first additional reporting standard for financial statement audits is

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

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

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

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

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**Reporting on  
Compliance With  
Laws and  
Regulations and  
on Internal  
Control Over  
Financial  
Reporting**

**5.15.** The second additional reporting standard for financial statement audits is

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

**5.16** Auditors may report on compliance with laws and regulations and internal control over financial reporting in the report on the financial statements or in separate report(s). When auditors report on compliance and

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

internal control over financial reporting in the report on the financial statements, they should include an introduction summarizing key findings in the audit of the financial statements and the related compliance and internal control work. Auditors should not issue this introduction as a stand-alone report.

**5.16.1** When auditors report separately (including separate reports bound in the same document) on compliance with laws and regulations and internal control over financial reporting, the report on the financial statements should state that they are issuing those additional reports. The report on the financial statements should also state that the reports on compliance with laws and regulations and internal control over financial reporting are an integral part of a GAGAS audit, and, in considering the results of the audit, these reports should be read along with the auditors' report on the financial statements.

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Scope of Compliance  
and Internal Control  
Work

**5.17** Auditors should report the scope of their testing of compliance with laws and regulations and of internal control over financial reporting, including whether or not the tests they performed provided sufficient evidence to support an opinion on compliance or internal control over financial reporting and whether the auditors are providing such opinions.

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Fraud, Illegal Acts,  
and Other  
Noncompliance

**5.18** When auditors conclude, based on evidence obtained, that fraud or an illegal act either has occurred or is likely to have occurred,<sup>4</sup> they should report relevant information. Auditors need not report information about fraud or an illegal act that is clearly inconsequential. Thus, auditors should present in a

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

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## Amendment No. 2: Auditor Communication

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report the same fraud and illegal acts that they report to audit committees under AICPA standards. Auditors should also report other noncompliance (for example, a violation of a contract provision) that is material to the financial statements.

**5.19** In reporting material fraud, illegal acts, or other noncompliance, the auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence and consequences of these conditions, the instances identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate.<sup>5</sup> In presenting material fraud, illegal acts, or other noncompliance, auditors should follow chapter 7's report contents standards for objectives, scope, and methodology; audit results; views of responsible officials; and its report presentation standards, as appropriate. Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.<sup>6</sup>

**5.20** When auditors detect fraud, illegal acts, or other noncompliance that do not meet paragraph 5.18's criteria for reporting, they should communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they report on compliance.

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

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

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## Amendment No. 2: Auditor Communication

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Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, and other noncompliance.

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### Direct Reporting of Fraud and Illegal Acts

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

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

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

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

provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

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

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

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**Deficiencies in  
Internal Control**

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

- a.** absence of appropriate segregation of duties consistent with appropriate control objectives;
- b.** absence of appropriate reviews and approvals of transactions, accounting entries, or systems output;
- c.** inadequate provisions for the safeguarding of assets;
- d.** evidence of failure to safeguard assets from loss, damage, or misappropriation;

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## Amendment No. 2: Auditor Communication

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- e. evidence that a system fails to provide complete and accurate output consistent with the auditee's control objectives because of the misapplication of control procedures;
- f. evidence of intentional override of internal control by those in authority to the detriment of the overall objectives of the system;
- g. evidence of failure to perform tasks that are part of internal control, such as reconciliations not prepared or not timely prepared;
- h. absence of a sufficient level of control consciousness within the organization;
- i. significant deficiencies in the design or operation of internal control that could result in violations of laws and regulations having a direct and material effect on the financial statements; and
- j. failure to follow up and correct previously identified deficiencies in internal control.<sup>8</sup>

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

**5.28** When auditors detect deficiencies in internal control that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated other deficiencies in internal control in a

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

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

management letter to top management, they should refer to that management letter when they report on internal control. All communications to the auditee about deficiencies in internal control should be documented in the working papers.

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Privileged and  
Confidential  
Information

5.29 The third additional reporting standard for financial statement audits is

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

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

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

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Report  
Distribution

5.32 The fourth additional reporting standard for financial statement audits is

**Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audits, including external funding organizations, unless legal restrictions prevent it. Copies of the reports should also be sent to other officials who have legal oversight authority or who may be**

**responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection.<sup>10</sup>**

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

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

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

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## **Financial Related Audits**

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

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<sup>10</sup>See the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133 for the distribution of reports on single audits of state and local governmental entities and nonprofit organizations that receive federal awards.

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

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**Amendment No. 2: Auditor Communication**

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**a. SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specific Elements, Accounts, or Items of a Financial Statement*;**

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

**c. SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, for testing compliance with laws and regulations applicable to federal financial assistance programs;**

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

**e. Statement on Standards for Attestation Engagements (SSAE) No. 1, *Attestation Standards*, as amended by SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for examining or reviewing an entity's assertions about financial related matters not specifically addressed in other AICPA standards;**

**f. SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting*, as amended by SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for examining an entity's assertions about its internal control over financial reporting and/or safeguarding assets;**

**g. SSAE No. 3, *Compliance Attestation*, as amended by SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for (1) examining or applying agreed-upon procedures to an entity's assertions about compliance with specified requirements or (2) applying agreed-upon procedures to an entity's assertions about internal control over compliance with laws and regulations; and**

**h. SSAE No. 4, *Agreed-Upon Procedures Engagements*, for applying agreed-upon procedures to (1) an entity's assertions about internal control over financial reporting and/or safeguarding of assets or (2) an entity's assertions about financial related matters not specifically addressed in other AICPA standards.**

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

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

## Chapter 4

# Field Work Standards for Financial Audits

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*This amendment to Government Auditing Standards (1994 revision) establishes a new field work standard and revises a reporting standard for financial statement audits to improve auditor communication concerning the auditor's work on compliance with laws and regulations and internal control over financial reporting with users of the auditor's reports. This standard is effective for financial statement audits of periods ending on or after January 1, 2000. Earlier application is permissible.*

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### Purpose

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

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### Relation to AICPA Standards

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

- a. The work is to be adequately planned and assistants, if any, are to be properly supervised.
- b. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- c. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

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

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

chapter incorporates these SASs and prescribes additional standards on

**a. auditor communication (see paragraphs 4.6.3 through 4.6.9),**

**b. audit follow-up (see paragraphs 4.7, 4.10, and 4.11),**

**c. noncompliance other than illegal acts (see paragraphs 4.13 and 4.18 through 4.20),**

**d. documentation requirements when assessing control risk at maximum for controls significantly dependent upon computerized information systems (see paragraphs 4.21.1 through 4.21.4), and**

**e. working papers. (See paragraphs 4.34 through 4.38.)**

**4.4 This chapter also *discusses* presents discussions of three other key aspects of financial statement audits:**

**a. materiality (see paragraphs 4.86.1 and 4.96.2),**

**b. fraud and illegal acts (see paragraphs 4.14 through 4.17), and**

**c. internal control. (See paragraphs 4.22 and 4.25 through 4.30.)**

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

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## Planning

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

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

**4.86.1** Auditors' consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

**4.96.2** In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.

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**Auditor  
Communication**

**4.6.3** *The first additional planning standard for financial statement audits is*

***Auditors should communicate information to the auditee, the individuals contracting for or requesting the audit services, and the audit committee regarding the nature and extent of planned testing and reporting on compliance with laws and regulations and internal control over financial reporting.***

**4.6.4** *AICPA standards and GAGAS require auditors to establish an understanding with the client and to communicate with audit committees. GAGAS broaden who auditors must communicate with and require auditors to communicate specific information regarding the nature and extent of testing and reporting on compliance with laws and regulations and internal control over financial reporting during the planning stages of a financial statement audit to reduce the risk that the needs or expectations of the parties involved may be misinterpreted.*

**4.6.5 The auditee is the organization or entity being audited. Auditors should communicate their responsibilities for the engagement to the appropriate officials of the auditee (which would normally include the head of the organization, the audit committee or board of directors or other equivalent oversight body in the absence of an audit committee, and the individual who possesses a sufficient level of authority and responsibility for the financial reporting process, such as the chief financial officer). In situations where auditors are performing the audit under a contract with a party other than the auditee, or pursuant to a third-party request, auditors should also communicate with the individuals contracting for or requesting the audit, such as contracting officials or legislative members or staff. When auditors are performing the audit pursuant to a law or regulation, auditors should communicate with the legislative members or staff who have oversight of the auditee.<sup>1,1</sup>**

**4.6.6 During the planning stages of an audit, auditors should communicate their responsibilities in a financial statement audit, including their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting. Such communication should include the nature of any additional testing of compliance and internal control required by laws and regulations or otherwise requested, and whether the auditors are planning on providing opinions on compliance with laws and regulations and internal control over financial reporting.**

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<sup>1,1</sup> This requirement applies only to situations where the law or regulation specifically identifies the entity to be audited, such as an audit of a specific agency's financial statements required by the Chief Financial Officers Act, as expanded by the Government Management Reform Act of 1994. Situations where the financial statement audit mandate applies to entities not specifically identified, such as audits required by the Single Audit Act Amendments of 1996, are excluded.

**4.6.7 Auditors should use their professional judgment to determine the form and content of the communication. Written communication is preferred. Auditors should document the communication in the working papers. Auditors may use an engagement letter to communicate the information described in paragraph 4.6.6. To assist in understanding the limitations of auditors' responsibilities for testing and reporting on compliance and internal control over financial reporting, auditors may want to contrast those responsibilities with other financial related audits of compliance and controls. The discussion in paragraphs 4.6.8 and 4.6.9 may be helpful to auditors in explaining their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting to the auditee and other interested parties.**

**4.6.8 Tests of compliance with laws and regulations and internal control over financial reporting in a financial statement audit contribute to the evidence supporting the auditors' opinion on the financial statements. However, they generally do not provide a basis for opining on compliance or internal control over financial reporting. To meet certain audit report users' needs, laws and regulations sometimes prescribe testing and reporting on compliance and internal control over financial reporting to supplement the financial statement audit's coverage of these areas.<sup>1,2</sup>**

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<sup>1,2</sup>For example, when engaged to perform audits under the Single Audit Act of state and local government entities and nonprofit organizations that receive federal awards, auditors should be familiar with the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133. The act and circular include specific audit requirements, mainly in the areas of compliance with laws and regulations and internal control, that exceed the minimum audit requirements in the standards in chapters 4 and 5 of this document. Audits conducted under the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, also have specific audit requirements prescribed by OMB in the areas of compliance and internal control. Many state and local governments have additional audit requirements.

**4.6.9 Even after auditors perform and report the results of additional tests of compliance and internal control over financial reporting required by laws and regulations, some reasonable needs of report users still may be unmet. Auditors may meet these needs by performing further tests of compliance and internal control in either of two ways:**

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

**4.7 The *second* additional planning standard for financial statement audits is**

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

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***Materiality***

***[Paragraphs 4.8 and 4.9 have been moved and renumbered to paragraphs 4.6.1 and 4.6.2.]***

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***Audit Follow-up***

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

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

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**Irregularities**  
**Fraud, Illegal**  
**Acts, and Other**  
**Noncompliance**

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

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

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

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

**4.13** The additional compliance standard for financial statement audits is

**Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with**

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<sup>2</sup>Irregularities are intentional misstatements or omissions of amounts or disclosures in financial statements. *Two types of misstatements are relevant to the auditors' consideration of fraud in a financial statement audit—misstatements arising from fraudulent financial statements 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.*

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

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

provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible noncompliance that could have a material indirect effect on the financial statements, auditors should apply audit procedures specifically directed to ascertaining whether that noncompliance has occurred.

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Auditors'  
Understanding of  
Possible  
Irregularities **Fraud**  
and of Laws and  
Regulations

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

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

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

Due Care Concerning  
Possible  
**Irregularities Fraud**  
and Illegal Acts

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

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

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Noncompliance Other  
Than Illegal Acts

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

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

**4.20** Indirect noncompliance is noncompliance having material but indirect effects on the financial statements.

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

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## Internal Control

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

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

**4.21.1** AICPA standards and GAGAS require that, in all audits, the auditors obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand (1) the design of controls relevant to an audit of financial statements and (2) whether the controls have been placed in operation. This understanding should include a consideration of the methods an entity uses to process accounting information because such methods influence the design of internal control. The extent to which computerized information systems are used in significant accounting applications,<sup>6.1</sup> as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in planning the audit and in obtaining an understanding of internal control over an entity's computer processing, the auditors should consider, among other things, such matters as

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<sup>6.1</sup>Significant accounting applications are those which relate to accounting information that can materially affect the financial statements the auditor is auditing. Significant accounting applications could include financial as well as other systems, such as management information systems or systems that monitor compliance, if they provide data for material account balances, transaction classes, and disclosure components of financial statements.

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- a. the extent to which computer processing is used in each significant accounting application;<sup>5,2</sup>
- b. the complexity of the entity's computer operations;
- c. the organizational structure of the computer processing activities; and
- d. the kinds and competence of available evidential matter, in electronic and in paper formats, to achieve audit objectives.

**4.21.2** AICPA standards and GAGAS require auditors to document their understanding of the components of an entity's internal control related to computer applications that process information used in preparing an entity's financial statements and, based on that understanding, to develop a planned audit approach in sufficient detail to demonstrate its effectiveness in reducing audit risk. In doing so, under AICPA standards and GAGAS, the auditors should consider whether specialized skills are needed for considering the effect of computerized information systems on the audit, understanding internal control, or designing and performing audit procedures, including tests of internal control. If the use of a professional with specialized skills is planned, the auditors should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditors' objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

**4.21.3** The additional internal control standard for financial statement audits is

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<sup>5,2</sup>Obtaining an understanding of these elements would include consideration of internal control related to security over computerized information systems.

**In planning the audit, auditors should document in the working papers (1) the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, and (2) consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.**

**4.21.4** This additional GAGAS standard does not increase the auditors' responsibility for testing controls, but rather requires that, if the auditors assesses control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, the auditors should document in the working papers<sup>5.3</sup> the basis for that conclusion by addressing (1) the ineffectiveness of the design and/or operation of the controls, or (2) the reasons why it would be inefficient to test the controls. In such circumstances, GAGAS also require the auditors to document in the working papers the consideration that the planned audit procedures are designed to achieve specific audit objectives and, accordingly, to reduce audit risk to an acceptable level. This documentation should address

- a.** the rationale for determining the nature, timing, and extent of planned audit procedures;
- b.** the kinds and competence of available evidential matter produced outside a computerized information system; and

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<sup>5.3</sup> See paragraphs 4.34 through 4.38 for a discussion of the working paper standards.

c. the effect on the audit opinion or report if evidential matter to be gathered during the audit does not afford a reasonable basis for the auditor's opinion on the financial statements.

**4.22** Safeguarding of assets and compliance with laws and regulations are internal control objectives that are especially important in conducting financial statement audits in accordance with GAGAS of governmental entities or others receiving government funds. Given the public accountability for stewardship of resources, safeguarding of assets permeates control objectives and components as defined by the AICPA standards and GAGAS. Also, the operation of government programs and the related transactions that materially affect the entity's financial statements are generally governed by laws and regulations. Although GAGAS are not prescribing additional internal control standards in these areas, this chapter provides a discussion that auditors may find useful in assessing audit risk and in obtaining evidence needed to support their opinion on the financial statements in a governmental environment.

[Paragraphs 4.23 and 4.24 deleted.]

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**Safeguarding of  
Assets**

**4.25** As applied to financial statement audits, internal control over safeguarding of assets constitutes a process, effected by an entity's governing body, management, and other detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

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

to help ensure the use of and access to assets are in accordance with management's authorization. Authorization includes approval of transactions in accordance with control activities established by management to safeguard assets, such as establishing and complying with requirements for extending and monitoring credit or making investment decisions, and related documentation. Control over safeguarding of assets is not designed to protect against loss of assets arising from inefficiency or from management's operating decisions, such as incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory.

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

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

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

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

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

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Control Over  
Compliance With  
Laws and  
Regulations

**4.29.1** Governmental entities are subject to a variety of laws and regulations that affect their financial statements, which is a major factor distinguishing governmental accounting from commercial accounting. For example, such laws and regulations may address the required fund structure, procurement or debt limitations, or authority for transactions. Accordingly, compliance with such laws and regulations may have a direct and material effect on the determination of amounts in the financial statements of governmental entities. Likewise, organizations that receive government assistance, such as contractors, nonprofit organizations, and other nongovernmental organizations, are also subject to regulations, contract provisions, or grant agreements that could have a direct and material effect on their financial statements. Management, of both governmental entities and others receiving governmental assistance, is responsible for ensuring that the entity complies with the laws and regulations applicable to its activities. That responsibility encompasses the identification of applicable laws and regulations and the establishment of controls designed to provide reasonable assurance that the entity complies with those laws and regulations.

**4.30** AICPA standards and GAGAS require auditors to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. To meet that requirement, auditors should have an understanding of internal control relevant to financial statement assertions affected by those laws and regulations. Auditors should use that understanding to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. For example, the following factors may influence the auditors' assessment of control risk:

- a. management's awareness or lack of awareness of applicable laws and regulations;

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b. auditee policy regarding such matters as acceptable operating practices and codes of conduct; and

c. assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.

[Paragraphs 4.31 through 4.33 deleted.]

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## Working Papers

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

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

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

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

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

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### 4.37 Working papers should contain

- a. the objectives, scope, and methodology, including any sampling criteria used;
- b. documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records;<sup>6</sup> and
- c. evidence of supervisory reviews of the work performed.

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

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## Financial Related Audits

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

- a. SAS no. 35, Special Reports - Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement *SAS No. 75, Engagements to Apply Agreed-Upon Procedures to Specific*

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

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

***Elements, Accounts, or Items of a Financial Statement;***

- b. SAS nNo. 62, *Special Reports*, for auditing specified elements, accounts, or items of a financial statement;
- c. ~~SAS no. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*~~ ***SAS No. 74, Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance***, for testing compliance with laws and regulations applicable to federal financial assistance programs;
- d. SAS nNo. 70, *Reports on the Processing of Transactions by Service Organizations*, for examining descriptions of internal controls of service organizations that process transactions for others;
- e. Statement on Standards for Attestation Engagements (SSAE) nNo. 1, *Attestation Standards, as amended by SSAE No. 9, Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for ~~(1) applying agreed-upon procedures to an entity's assertions about internal controls over financial reporting and/or safeguarding assets or (2) examining or reviewing applying agreed-upon procedures to an~~ entity's assertions about financial related matters not specifically addressed in other AICPA standards;
- f. SSAE nNo. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting, as amended by SSAE No. 9, Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for examining an entity's assertions about its internal controls over financial reporting and/or safeguarding assets; and

**g. SSAE #No. 3, Compliance Attestation, as amended by SSAE No. 9, Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3, for (1) examining or applying agreed-upon procedures to an entity's assertions about compliance with laws and regulations *specified requirements* or (2) applying agreed-upon procedures to an entity's assertions about internal controls over compliance with laws and regulations; and**

**h. SSAE No. 4, Agreed-Upon Procedures Engagements, for applying agreed-upon procedures to (1) an entity's assertions about internal control over financial reporting and/or safeguarding assets or (2) an entity's assertions about financial related matters not specifically addressed in other AICPA standards.**

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

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

# Chapter 5

## Reporting Standards for Financial Audits

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### Purpose

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

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### Relation to AICPA Standards

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

- a. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
- b. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
- c. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- d. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

**5.3** The AICPA has issued statements on auditing standards (SAS) that interpret its standards of reporting.<sup>1</sup> This chapter incorporates these SASs and prescribes additional standards on

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

~~a. communication with audit committees or other responsible individuals (see paragraphs 5.5 through 5.10),~~

~~ba.~~ reporting compliance with GAGAS (see paragraphs 5.11 through 5.14),

~~eb.~~ reporting on compliance with laws and regulations and on internal controls **over financial reporting** (see paragraphs 5.15 through 5.28),

~~dc.~~ privileged and confidential information (see paragraphs 5.29 through 5.31), and

~~ed.~~ report distribution. (See paragraphs 5.32 through 5.35.)

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

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## Communication with Audit Committees or Other Responsible Individuals

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

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

~~5.6~~ This standard applies in all situations where either the auditee has an audit committee or the audit is performed under contract. In other situations, auditors may still find it useful to communicate with management or other officials of the auditee.

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

~~a.~~ the auditors' responsibilities in a financial statement audit, including their responsibilities for testing and reporting on internal controls and compliance with laws and regulations and

b. the nature of any additional testing of internal controls and compliance required by laws and regulations.

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

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

~~5.10 To meet certain audit report users' needs, laws and regulations often prescribe testing and reporting on internal controls and compliance to supplement the financial statement audit's coverage of these areas.<sup>3</sup>~~

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<sup>3</sup> For example, when auditing state and local government entities that receive federal financial assistance, auditors should be familiar with the Single Audit Act of 1984 and Office of Management and Budget (OMB) Circular A-128. The act and circular include specific audit requirements, mainly in the areas of internal controls and compliance with laws and regulations, that exceed the minimum audit requirements in the standards in chapters 4 and 5 of this document. Audits of nonprofit organizations under OMB Circular A-133 and audits conducted under the Chief Financial Officers Act of 1990 also have specific audit requirements in the areas of internal controls and compliance. Many state and local governments have similar requirements.

~~Nevertheless, even after auditors perform, and report the results of, additional tests of internal controls and compliance required by laws and regulations, some reasonable needs of report users still may be unmet. Auditors may meet these needs by performing further tests of internal controls and compliance with laws and regulations in either of two ways:~~

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

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**Reporting  
Compliance With  
Generally  
Accepted  
Government  
Auditing  
Standards**

**5.11** The ~~second~~ **first** additional reporting standard for financial statement audits is

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

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

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

**5.14** The auditee may need a financial statement audit for purposes other than to comply with requirements calling for a GAGAS audit. For example, it may need a financial statement audit to issue bonds. GAGAS do not prohibit auditors from issuing a separate report on the financial statements conforming only to the requirements

of AICPA standards. However, it may be advantageous to use a report issued in accordance with GAGAS for these other purposes because it provides information on compliance with laws and regulations and internal controls (as discussed below) that is not contained in a report issued in accordance with AICPA standards.

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**Reporting on  
Compliance With  
Laws and  
Regulations and  
on Internal  
Controls Over  
Financial  
Reporting**

**5.15** The ~~third~~ *second* additional reporting standard for financial statement audits is

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

**5.16** Auditors may report on compliance with laws and regulations and internal controls *over financial reporting* in the report on the financial statements or in *the* separate report(s). When auditors report on compliance and *internal controls over financial reporting* in the report on the financial statements, they should include an introduction summarizing key findings in the audit of the financial statements and the related compliance and internal controls work. Auditors should not issue this introduction as a stand-alone report.

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

**5.16.1 When auditors report separately (including separate reports bound in the same document) on compliance with laws and regulations and internal control over financial reporting, the report on the financial statements should state that they are issuing those additional reports. The report on the financial statements should also state that the reports on compliance with laws and regulations and internal control over financial reporting are an integral part of a GAGAS audit, and, in considering the results of the audit, these reports should be read along with the auditor's report on the financial statements.**

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Scope of Compliance  
and Internal Controls  
Work

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

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Irregularities—**Fraud**,  
Illegal Acts, and Other  
Noncompliance

**5.18 When auditors conclude, based on evidence obtained, that an irregularity **fraud** or **an** illegal act either has occurred or is likely to have occurred,<sup>4</sup> they should report relevant information. Auditors need not report information about an irregularity **fraud** or **an** illegal act that is clearly inconsequential. Thus, auditors should**

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

present in a report the same **irregularities fraud** and illegal acts that they report to audit committees under AICPA standards. Auditors should also report other noncompliance (for example, a violation of a contract provision) that is material to the financial statements.

**5.19** In reporting material **irregularities fraud**, illegal acts, or other noncompliance, the auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence and consequences of these conditions, the instances identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate.<sup>5</sup> In presenting material **irregularities fraud**, illegal acts, or other noncompliance, auditors should follow chapter 7's report contents standards for objectives, scope, and methodology; audit results; views of responsible officials; and its report presentation standards, as appropriate. Auditors may provide less extensive disclosure of **irregularities fraud** and illegal acts that are not material in either a quantitative or qualitative sense.<sup>6</sup>

**5.20** When auditors detect **irregularities fraud**, illegal acts, or other noncompliance that do not meet paragraph 5.18's criteria for reporting, they should communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter

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

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

to top management, they should refer to that management letter when they report on compliance. Auditors should document in their working papers all communications to the auditee about **irregularities fraud**, illegal acts, and other noncompliance.

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**Direct Reporting of  
Irregularities *Fraud*  
and Illegal Acts**

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

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

**5.23** Management is responsible for taking timely and appropriate steps to remedy **irregularities fraud** or illegal acts that auditors report to it. When **an irregularity fraud** or **an** illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statements or resign from the audit, then they should

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

communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the **irregularity fraud** or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the **irregularity fraud** or illegal act directly to that entity.

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

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

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Deficiencies in  
Internal Controls

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

- a. absence of appropriate segregation of duties consistent with appropriate control objectives;
- b. absence of appropriate reviews and approvals of transactions, accounting entries, or systems output;

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- c. inadequate provisions for the safeguarding of assets;
- d. evidence of failure to safeguard assets from loss, damage, or misappropriation;
- e. evidence that a system fails to provide complete and accurate output consistent with the auditee's control objectives because of the misapplication of control procedures;
- f. evidence of intentional override of internal controls by those in authority to the detriment of the overall objectives of the system;
- g. evidence of failure to perform tasks that are part of internal controls, such as reconciliations not prepared or not timely prepared;
- h. absence of a sufficient level of control consciousness within the organization;
- i. significant deficiencies in the design or operation of internal controls that could result in violations of laws and regulations having a direct and material effect on the financial statements; and
- j. failure to follow up and correct previously identified deficiencies in internal controls.<sup>8</sup>

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

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

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

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## Appendix II

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

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### Privileged and Confidential Information

**5.29** The ~~fourth~~ **third** additional reporting standard for financial statement audits is

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

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

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

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### Report Distribution

**5.32** The ~~fifth~~ **fourth** additional reporting standard for financial statement audits is

**Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audits,**

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

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

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

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

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<sup>10</sup>See the Single Audit Act of 1984 *Amendments of 1996* and *Office of Management and Budget* (OMB) Circular A-128~~133~~ for the distribution of reports on single audits of state and local governments *governmental entities and nonprofit organizations that receive federal awards*.

**Financial Related Audits**

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

a. ~~SAS no. 35, *Special Reports - Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*~~ **SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specific Elements, Accounts, or Items of a Financial Statement***;

b. SAS nNo. 62, *Special Reports*, for auditing specified elements, accounts, or items of a financial statement;

c. ~~SAS no. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*~~ **SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance***, for testing compliance with laws and regulations applicable to federal financial assistance programs;

d. SAS nNo. 70, *Reports on the Processing of Transactions by Service Organizations*, for examining descriptions of internal controls of service organizations that process transactions for others;

e. Statement on Standards for Attestation Engagements (SSAE) nNo. 1, *Attestation Standards, as amended by SSAE No. 9, Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, for (1) applying agreed-upon procedures to an entity's assertions about internal controls over financial reporting and/or safeguarding assets or (2) examining or reviewing applying agreed-upon procedures to an entity's assertions about financial related matters not specifically addressed in other AICPA standards;

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

**f. SSAE No. 2, Reporting on an Entity's Internal Control Structure Over Financial Reporting, as amended by SSAE No. 9, Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3, for examining an entity's assertions about its internal controls over financial reporting and/or safeguarding assets; and**

**g. SSAE No. 3, Compliance Attestation, as amended by SSAE No. 9, Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3, for (1) examining or applying agreed-upon procedures to an entity's assertions about compliance with laws and regulations *specified requirements* or (2) applying agreed-upon procedures to an entity's assertions about internal controls over compliance with laws and regulations *specified requirements*; and**

**h. SSAE No. 4, Agreed-Upon Procedures Engagements, for applying agreed-upon procedures to (1) an entity's assertions about internal control over financial reporting and/or safeguarding assets or (2) an entity's assertions about financial related matters not specifically addressed in other AICPA standards.**

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

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

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