Major topics discussed in this chapter are:

- **Compliance auditing:**
  - Distinguishing among financial statement, compliance, and internal auditing.
  - Auditing compliance with laws and regulations under generally accepted auditing standards.
  - Auditing under the GAO’s government auditing standards.
  - Auditing under the Single Audit Act and OMB Circular A-133, “Audits of State, Local Governments, and Non-profit Organizations.”

- **Internal auditing:**
  - The role of independence in internal auditing.
  - The nature and types of internal operational audits.
  - How internal auditors perform operational audits.
  - The relationship between internal and independent financial statement auditing.

Financial statement, compliance, and internal audits are distinctly different and, for that matter, each provides unique professional responsibilities, opportunities, and challenges to its practitioners. Figure 19-1 distinguishes these three types of audits and indicates the professional standards governing each. This chapter, devoted exclusively to compliance auditing and internal auditing, serves as a basis for comparing financial statement auditing with two other dominant audit activities practiced in the United States. Governmental compliance auditing is discussed first, followed thereafter by internal auditing.
Compliance and Internal Auditing

In much-publicized reports, the GAO revealed that certified public accountants repeatedly failed to comply with applicable laws and regulations, failed to consider internal control, and failed to follow generally accepted auditing standards. In response, an AICPA Task Force recommended that the Auditing Standards Board provide guidance to practitioners about testing and reporting on the laws and regulations that govern a governmental entity. In 1991, the board issued a statement on auditing standards, which, owing to changes in federal law, was superseded in 1995 by today’s SAS No. 74, “Compliance Auditing Applicable to Governmental Entities and to Other Recipients of Governmental Financial Assistance.” SAS No. 74 documents an auditor’s responsibilities for complying with:

- Laws and regulations under generally accepted auditing standards.
- The GAO’s government auditing standards.
- The Single Audit Act.

Other types of compliance audits are performed in the United States. For example, public accounting firms offer audits of a company’s compliance with minimum wage laws, employee benefits programs, and commercial bank lending agreements. And, state governmental auditors perform a number of special engagements assigned by elected state legislatures. For example, a Georgia state audit or Georgia’s Hazardous Waste Trust Fund detected a $214 million shortfall, and a Tennessee state audit of TennCare, Tennessee’s state-sponsored health insurance program for the otherwise uninsured, found that the agency spent $6 million to cover 14,000 residents who had died. However, the discussion here focuses on governmental compliance audits because they are so topical, having captured the attention of Congress, the financial press, the GAO, and the Auditing Standards Board.
Standards Board. The next three sections of the chapter discuss each of an auditor’s threefold responsibilities under SAS No. 74.

**Responsibilities Under Generally Accepted Auditing Standards**

Governmental entities are subject to a variety of laws and regulations not generally applicable to private-sector, profit-making entities. For example, local laws may restrict the authority of a municipality to assess taxes or issue debt, state law may require that proceeds received from a tax assessment be accounted for in a special revenue fund, and federal law may restrict the disbursement of social service payments to eligible applicants. Violations of any of these, among other laws and regulations, could have a direct and material effect on a reporting entity’s financial statements. For example, if a state receives a federal allocation for state welfare payments, disbursements to ineligible recipients may require that the state’s department of health and human services disclose a contingent liability for potential fines and penalties payable to the federal government.

Under SAS No. 74, an auditor’s responsibility for detecting violations of laws and regulations is identical to the auditor’s responsibility for client errors, for fraud, and for illegal acts, all of which are discussed in Chapters 5 and 7. That is, the auditor should assess the risk that violations of laws and regulations may cause the financial statements to contain a direct and material misstatement and should consider the assessment in designing the audit procedures to be performed. In practice, this responsibility imposes two specific requirements on the auditor: to understand the effects of laws and regulations on a governmental entity’s financial statements and to assess risk, both of which are discussed next.

**The Effects of Laws and Regulations and the Assessment of Risk**

In planning a compliance audit, an auditor assesses whether management has identified laws and regulations that have a direct and material effect on the financial statements. The auditor also performs the procedures in Figure 19-2 to assess whether management overlooked relevant laws or regulations and to develop an understanding of potential effects on the financial statements.

Having identified relevant laws and regulations, the auditor next assesses the risk of material misstatement arising from violations, based on two issues: First, the auditor considers the nature, cause, and amount of known and likely misstatements detected in prior audits. Second, the auditor considers the competence of client personnel responsible for complying with applicable laws and regulations, and the organizational structure of management. For example, an auditor is likely to assess risk at the maximum for a governmental entity that is decentralized and does not monitor employees adequately.

**Internal Control**

As explained in Chapter 8, the second standard of field work requires that an auditor obtain an understanding of an entity’s internal controls sufficient to plan the audit and to assess control risk. Obtaining an understanding in a compliance audit also requires that the auditor obtain knowledge about the design—and performance—of internal control policies and procedures relevant to assertions affected
by compliance with laws and regulations. For example, in obtaining an understanding of the components of internal control—the control environment, risk assessment, control activities, information and communication, and monitoring (Chapter 8)—the auditor may learn that the control environment is affected significantly by management’s lack of awareness about applicable laws and regulations. Deficiencies like these should affect the auditor’s assessment of control risk and should be reported to the governmental entity’s oversight authority (for example, the city council) under SAS No. 60, “Communication of Internal Control Related Matters Noted in an Audit” (Chapter 8).

**Government Auditing Standards**

Headed by the Comptroller General of the United States, the U.S. GAO is a non-political federal agency responsible for conducting audits on behalf of Congress. The GAO publishes *Government Auditing Standards* (often called the “Yellow Book”), an authoritative document that defines generally accepted government auditing standards (sometimes referred to by the acronym “GAGAS”). GAGAS (or as some auditors say for short, “GAS”) includes all ten of the AICPA’s generally accepted auditing standards (Chapter 2) plus additional standards related, for example, to independence, quality control, audit documentation, and legal and regulatory requirements. The Yellow Book, revised and reissued in 2003, identifies three types of generally accepted governmental engagements:

- Financial audits,
- Attestation engagements, and
- Performance audits.

Like financial statement audits for nongovernmental entities, governmental financial audits for governmental entities offer assurance about whether financial

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statements present fairly in all material respects financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP) or with a comprehensive basis of accounting other than GAAP. Other types of governmental financial audits offer less assurance, among them reports on specified elements, items, or accounts in a set of financial statements; interim financial information; and letters for underwriters—all of which were introduced in Chapter 18 in the context of nongovernmental entities. The punchline is that governmental entities differ dramatically from nongovernmental entities—for example, unlike public companies, governmental entities have no profit motive—but financial audits for either have largely the same objectives. For example, audits of financial statements for governmental and for nongovernmental entities all follow the AICPA’s generally accepted auditing standards (Chapter 2) and the Auditing Standards Boards’ Statements on Auditing Standards, although the “Yellow Book” adds additional field work and reporting standards, including a standard to be alert to financial abuse, such as business travel planned largely for personal vacation.

Not unlike attestation engagements for nongovernmental entities (Chapters 1 and 18), attestation engagements for governmental entities examine, review, or perform agreed-upon engagements about a subject matter or an assertion—for example, historical or prospective financial information, or an assessment of internal control. In practice, governmental attestation engagements have reported on contract costs, compliance with laws or regulations, pro forma information, and management’s discussion and analysis in governmental bond offerings. Governmental attestation engagements follow the AICPA’s Statements on Standards for Attestation Engagements, although the “Yellow Book” includes additional fieldwork and reporting standards, such as an obligation to obtain and report management’s views about fraud or abuse an auditor detects.

Performance audits assess the performance and management of a governmental program—say, for example, a publicly funded elementary education grant—against objective criteria either specified in the grant program or compiled from best practices. In practice, performance audits take a variety of forms, among them economy and efficiency audits and program audits. Economy and efficiency audits determine (1) whether an entity acquires, protects, and uses resources economically and efficiently, (2) the causes of diseconomies or inefficiencies, and (3) whether the entity has complied with laws and regulations that bear on economy and efficiency. For example, having found in an economy and efficiency audit that Florida High School, an Orlando-based provider of Internet courses, enrolls fewer than ten students in most counties, the Florida Office of Program Policy Analysis and Government Accountability recommended intensive marketing efforts to increase the high school’s reach, particularly to parents of school age children.

Program audits determine (1) the extent to which a program achieves the results or benefits established by the granting legislature or authorizing body; (2) the effectiveness of an organization, program, activity, or function; and (3) whether the entity complies with laws and regulations applicable to the program.

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For example, a Florida Office of Program Policy Analysis and Government Accountability program audit of a statewide enterprise-zone program designed to attract business to the state’s most economically distressed rural communities found that, although 34 zones awarded more than $21 million in sales and property tax incentives, 83 percent of the incentives went to three large urban zones. Underscoring the need to prevent further noncompliance, the report concluded, “The program is unlikely to have a substantial impact on redevelopment of an area if there is only a small amount of incentives being awarded within an entire enterprise zone area.”

Although performance audits are conducted frequently in practice, SAS No. 74 and this chapter focus on financial audits, the governmental audit that is most similar to financial statement audits of business entities. Note carefully that the main difference between a financial statement audit for a business and a governmental financial audit is that a governmental financial audit requires that an auditor assume more responsibility. The additional responsibility is to report on compliance with laws and regulations and on internal control, each of which is addressed next.

### Reporting on Compliance with Laws and Regulations

In a governmental financial audit, the auditor is required to test an entity’s compliance with applicable laws and regulations and to prepare a written report that provides:

- Positive assurance on the results of tests for noncompliance, and
- A description of material instances of noncompliance, if any.

For example, assume that, coincident with tests designed to determine whether a governmental entity’s financial statements are free of material misstatement, an auditor tests items subject to laws or regulations but detects no material instances of noncompliance. In this case, the auditor provides positive assurance using language such as, “The results of our tests disclosed no instances of noncompliance . . .” Figure 19-3 illustrates a report for an entity in which the auditor detects material instances of noncompliance.

### Reporting on Internal Control

As discussed in Chapter 8, SAS No. 60, “Communication of Internal Control Related Matters Noted in an Audit,” requires in a financial statement audit that an auditor communicate reportable conditions to the board of directors’ audit committee (or to individuals with equivalent responsibility and authority). Government auditing standards go further. Whereas SAS No. 60 requires a report only when an auditor detects reportable conditions, government auditing standards require a report on internal control in all governmental financial audits, even when reportable conditions are not detected. In addition, government auditing standards require a report on internal control that is far more comprehensive than the SAS No. 60 report illustrated in Chapter 8. For example, a report under government auditing standards (1) describes the costs, benefits, objectives, and limitations of internal control; (2) states that the auditor assessed control risk; and

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(3) describes deficiencies in internal control not significant enough to be considered reportable conditions under SAS No. 60. Figure 19-4 illustrates a report on internal control when an auditor has noted reportable conditions.

FIGURE 19-4: Reporting on Internal Control: Reportable Conditions

We have audited the financial statements of the City of Lexington, Kentucky, as of and for the year ended June 30, 2007, and have issued our report thereon dated August 15, 2007.

We conducted our audit in accordance with generally accepted auditing standards and government auditing standards, issued by the Comptroller General of the United States.

Compliance with laws, regulations, contracts, and grants applicable to the City of Pawtucket, Rhode Island, is the responsibility of the City’s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the City’s compliance with certain provisions of laws, regulations, contracts, and grants.

However, the objective of our audit of the financial statements was not to provide an opinion on the overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in statutes, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in the City of Pawtucket, Rhode Island’s 2007 financial statements.

[Include paragraphs describing the material instances of noncompliance.]

We considered these material instances of noncompliance in forming our opinion on whether the City of Pawtucket, Rhode Island’s 2007 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 2007, on those financial statements.

This report is intended solely for the information of the audit committee, management, and the city council. This is not intended to limit the distribution of this report, which is a matter of public record.
Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the City of Lexington, Kentucky, is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management’s authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of the City of Lexington, Kentucky, as of and for the year ended August 15, 2007, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on internal control. Accordingly, we do not express an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the City’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of the City of Lexington, Kentucky, in a separate letter dated August 15, 2007.

This report is intended for the information of the audit committee, management, and city council. This is not intended to limit the distribution of this report, which is a matter of public record.
The Single Audit Act

Financial audits and performance audits are performed annually by governmental or independent auditors for the states, for state agencies, and for local governmental units such as cities, towns, counties, school districts, fire districts, housing authorities, and port authorities, among others. To assure accountability for federal grant funds received by these entities, the federal government required periodic audits of each grant received. For example, if a governmental unit participated in ten federal grant programs, then ten individual grant audits were required.

Because there was little coordination among federal, state, and local auditors, and because the requirements of each grant audit varied widely, the GAO and the Joint Management Improvement Program (JMIP) reported in 1979 that grant-by-grant audits often resulted in considerable duplication of effort: The same internal controls were studied and the same accounting records were audited. In short, grant-by-grant audits were not cost effective. As a result, both the GAO and the JMIP recommended that grant-by-grant audits be abandoned and be replaced by a single audit of each governmental unit receiving federal assistance—that is, one audit of the recipient entity rather than a separate audit of each grant received by the entity. In response, Congress enacted the Single Audit Act of 1984, which was intended to improve the financial management of state and local governments receiving federal funds, establish uniform audit requirements for federal grant recipients, promote efficient and effective use of audit resources, and ensure that federal departments and agencies rely on one audit report only: the single audit report. In 1996, the Act was amended by the Single Audit Act Amendment.

Audit Coverage

The Single Audit Act (and Amendment) applies to all governmental units that receive any federal assistance, although the reporting requirements of the Act apply generally to governments receiving over $300,000 in grant funds per year. Although far-reaching, the Single Audit Act does not limit the authority of federal agencies to conduct additional audits as deemed necessary. However, the single audit is the definitive audit of federal assistance programs and, as a result, additional audits must be done at the cost of the federal agency requiring the audit, not at the cost of the grant recipient.

Reports

In addition to a report on the general purpose financial statements required by generally accepted auditing standards and reports on compliance with laws and regulations and on internal control required by government auditing standards, the Single Audit Act and U.S. Office of Management and Budget (OMB) Circular A-133, “Audits of States, Local Governments, and Non-profit Organizations,” require no less than five additional reports:

- Report on Compliance with General Requirements.
- Report on Major Program Compliance with Specific Requirements.
- Report on Nonmajor Program Compliance with Specific Requirements.

Thus, a governmental entity subject to the Single Audit Act may require as many as eight separate reports (nine, if illegal acts are detected).
Chapter 19 Compliance and Internal Auditing

Report on Compliance with General Requirements The OMB’s “Compliance Supplement for Single Audits of State and Local Governments,” an interpretive supplement to OMB A-133, identifies nine “general requirements” that, according to the Supplement, involve significant national policy and that could have a material effect on an entity’s financial statements. Figure 19-5 lists the general requirements. An auditor is responsible to test an entity’s compliance with the nine general requirements using procedures suggested within the Compliance Supplement and to report—not give an opinion—on the results of the procedures performed. Figure 19-6 illustrates a report.

**FIGURE 19-5: The Single Audit Act: General Requirements**

- Political Activity: Prohibits the use of federal funds for partisan politics.
- Davis-Bacon Act: Requires that laborers working on federally financed construction projects be paid a wage not less than the prevailing regional wage established by the Secretary of Labor.
- Civil Rights: Prohibits violation of anyone’s civil rights in a program funded by the federal government.
- Cash Management: Requires recipients of federal financial assistance to minimize the time lapsed between receipt and disbursement of assistance.
- Relocation Assistance and Real Property Acquisition: Prescribes how real property should be acquired with federal financial assistance and how recipients must help relocate displaced people.
- Federal Financial Reports: Prescribes federal financial reports that must be filed.
- Allowable Cost/Cost Principle: Prescribes the direct and indirect costs allowable for federal reimbursement.
- Drug-Free Workplace: Prescribes that grantees must certify that they provide a drug-free workplace.
- Administrative Requirements: Prescribes additional administrative requirements.

Report on Major Program Compliance with Specific Requirements SAS No. 74 requires that an auditor perform auditing procedures designed to provide reasonable assurance of detecting material noncompliance with specific requirements applicable to major financial assistance programs. Unlike the nine general requirements, specific requirements vary across federal financial assistance programs, although they involve five categories of requirements, listed in Figure 19-7. Also unlike the report on general requirements, which relates to all federal financial assistance programs, the report on specific requirements relates only to major federal financial assistance programs, not to nonmajor programs. The distinction between major and nonmajor programs is based on risk. In general, a major program is determined from risk factors such as the auditee’s prior compliance violations and from cash and noncash (for example, food stamps) expenditures. For example, the threshold for determining a major program is about $300,000 in expenditures for the period audited, and increases as the total federal financial assistance expenditures increase. An auditor is responsible to test an entity’s compliance with major program-specific requirements using procedures suggested in the Compliance Supplement and to express an opinion on the entity’s compliance. Figure 19-8 illustrates an unqualified opinion on an entity’s compliance with specific requirements.
We have audited the financial statements of the City of South Bend, Indiana, as of and for the year ended June 30, 2007, and have issued our report thereon dated August 15, 2007.

We have applied procedures to test compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the schedule of federal financial assistance, for the year ended June 30, 2007.

[List the general requirements from Figure 19-5 that were tested.]

Our procedures were limited to the applicable procedures described in the Office of Management and Budget’s Compliance Supplement for Single Audits of State and Local Governments. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on the City of South Bend’s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that the City of South Bend, Indiana, had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.

This report is intended for the information of the audit committee, management, and city council. This is not intended to limit the distribution of this report, which is a matter of public record.

FIGURE 19-6: The Single Audit Act: Compliance with General Requirements

Figure 19-6: The Single Audit Act: Compliance with General Requirements

- Types of Services Allowed or Not Allowed: Specifies the types of goods or services entities may purchase with financial assistance.
- Eligibility: Specifies the characteristics of individuals or groups to whom entities may give financial assistance.
- Matching, Level of Effort, or Earmarking: Specifies amounts entities should contribute from their own resources toward projects from which financial assistance is provided.
- Reporting: Specifies reports entities must file in addition to those required by the general requirements.
- Special Tests and Provisions: Other provisions for which federal agencies have determined that noncompliance could materially affect the program.

FIGURE 19-7: The Single Audit Act: Specific Requirements

- Types of Services Allowed or Not Allowed: Specifies the types of goods or services entities may purchase with financial assistance.
- Eligibility: Specifies the characteristics of individuals or groups to whom entities may give financial assistance.
- Matching, Level of Effort, or Earmarking: Specifies amounts entities should contribute from their own resources toward projects from which financial assistance is provided.
- Reporting: Specifies reports entities must file in addition to those required by the general requirements.
- Special Tests and Provisions: Other provisions for which federal agencies have determined that noncompliance could materially affect the program.

Report on Nonmajor Program Compliance with Specific Requirements

In a financial audit of a state or local governmental entity, an auditor may have tested transactions selected from nonmajor federal financial assistance programs. The Single Audit Act and OMB Circular A-128 require that the transactions tested also be tested for compliance with applicable federal laws and regulations. Generally, auditors test these transactions for the allowability of the program expenditure
and for the eligibility of the individuals or groups to whom the entity disburses financial assistance. Figure 19-9 illustrates a report on testing compliance with the requirements applicable to nonmajor federal financial assistance programs.

**Report on the Schedule of Federal Financial Assistance** To comply with the *Single Audit Act*, all federal grant recipients prepare a schedule of federal financial assistance for purposes of additional analysis, not as a required part of the general purpose financial statements. Among other things, the schedule is required to identify all federal agencies granting funds to the governmental agency, all major programs, expenditures for each major program, and total federal financial assistance. The auditor’s report on the schedule provides an opinion on whether the schedule is fairly presented in all material respects in relation to the general purpose financial statements, not in relation to the schedule itself. That is, the auditor is responsible not for errors or frauds material to the schedule but rather for errors or frauds material to the financial statements.

**Report on Internal Controls over Federal Financial Assistance** Governmental entities subject to the *Single Audit Act* receive not one but two separate reports on internal control: a report on internal controls considered by the auditor when auditing the general purpose financial statements under government auditing standards (illustrated in Figure 19-4) and a separate report (required by the *Single
FIGURE 19-9: The Single Audit Act: Compliance with Specific Requirements

We have audited the financial statements of Michigan Regional Airport as of and for the year ended June 30, 2007, and have issued our report thereon dated August 15, 2007.

In connection with our audit of the financial statements of Michigan Regional Airport and with our consideration of the Michigan Regional Airport’s internal control structure used to administer federal financial assistance programs, and required by Office of Management and Budget Circular A-128, “Audits of State and Local Governments,” we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 2007. As required by Circular A-128, we have performed auditing procedures to test compliance with the requirements governing [list requirements tested] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on the Michigan Regional Airport’s compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that Michigan Regional Airport had not complied, in all material respects, with those requirements.

This report is intended for the information of the audit committee and management. This is not intended to limit the distribution of this report, which is a matter of public record.

Audit Act) on the entity’s internal controls over federal financial assistance programs. The auditor does not express an opinion on controls over federal financial assistance. Rather, he or she reports on weaknesses material to federal financial assistance programs. Note carefully the difference between the two reports: The report on internal control required by government auditing standards reports weaknesses material to the financial statements; the report required by the Single Audit Act reports weaknesses material to federal financial assistance programs.

Internal Auditing

In 1941, the first definitive internal auditing book, Victor Z. Brink’s Modern Internal Auditing, was published, and the Institute of Internal Auditors was founded, two landmark events in the rise of internal auditing as a profession. The Institute of Internal Auditors has grown from 24 charter members in 1941 to over 70,000 members worldwide today. In half a century, the Institute has done much to enhance the professional stature of internal auditors, among them approving a statement of responsibilities, developing a common body of knowledge and code of ethics, establishing continuing education and professional certification (Certified Internal Auditor) programs, and adopting standards for the professional practice of internal auditing.

Throughout the 1940s and 1950s, internal auditing in many organizations focused solely on financial auditing, and internal audit departments were heavily involved in the analysis of financial statements for management. Today, internal auditing takes on a much broader range of responsibility, as suggested in the def-
inition of internal auditing that appears in the Institute of Internal Auditors’ Standards for the Professional Practice of Internal Auditing, revised in 2001:

*Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.*

In practice, internal auditors perform a number of different and varied activities, such as appraising and recommending improvements for the:

- Adequacy and application of financial and operating controls.
- Extent of compliance with established policies, plans, and procedures.
- Extent to which assets are accounted for and safeguarded from loss.
- Prevention of loss and fraud.
- Reliability of information reported by management.
- Performance of employees and management.

The definition and activities describe the scope of operational auditing, the dominant activity of contemporary internal audit practice. Internal auditing is no longer confined to matters of financial reporting—it’s far broader, an opportunity to lend insight into issues not readily apparent to management, like projected cost savings on regional distribution centers for nationally marketed consumer products. However, this is not to say that internal auditing excludes internal financial auditing. For example, evidence the SEC used in a settlement with Boston Scientific managers accused of shipping unsold goods to Pacific Rim warehouses in a scheme to record fake sales reportedly was detected in an investigation by the company’s internal auditors.

**Independence and Objectivity in Internal Auditing**

Although the term “independent auditor” typically refers to auditors in independent public accounting firms, an internal auditor’s effectiveness depends crucially on his or her independence from the personnel and the activities of an organization. Otherwise, the integrity of an internal auditor’s conclusions and recommendations would lack credibility. For example, would you find credible a glowing report on a financial vice president’s projected financing strategy prepared by an internal auditor who reports directly to the vice president?

The Institute of Internal Auditors’ Standards for the Professional Practice of Internal Auditing underscores the significance of independence in a statement that identifies organizational status as a primary means for achieving independence:

*The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.*

In short, internal auditors should report to an organizational level above the levels audited—otherwise, they may not be inclined to criticize peers or superiors.

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For example, an internal auditor who reports to the chief financial officer (CFO) may be reluctant to report weaknesses in the CFO’s activities and support staff, weaknesses that may be counterproductive to the organization’s goals. On the other hand, an internal auditor who reports to the board of directors would not likely be reluctant to report weaknesses in staff levels below the board of directors. The higher the organizational level reported to, the greater the range of an internal auditor’s potential effectiveness.

In the decades following World War II, internal auditors in most organizations reported to a financial executive, such as the vice president of finance, since internal auditing translated largely to financial audits for internal use. However, in recent years, internal auditing has become increasingly oriented toward operational control, oversight, and protection, all of which are major responsibilities of the board of directors. As a result of the increased emphasis on serving the needs of the board of directors, rather than management, internal auditing has moved further away from financial auditing, its traditional role, and closer toward operational auditing, its emerging role. This trend, and the resulting effect on the internal auditor’s organizational status, is illustrated in the following excerpt from an article in The Wall Street Journal:

Worries about foreign payoffs and corporate accountability prompt more firms to expand the clout of internal audit staffs. About a third of internal audit managers now report to boards of directors, instead of to controllers, says a poll by John Stork & Partners, a search firm.

The Standards for the Professional Practice of Internal Auditing discuss objectivity as follows: “Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest.” Thus, internal auditors are not simply one of the organization’s controls—they are a control over all other controls. For this reason, while internal auditors can recommend controls, they should not design and implement the controls. Rather, to maximize their objectivity, internal auditors should serve the organization as independent appraisers of existing controls. To design, implement, and audit controls could result in a conflict of interests: Could an internal auditor objectively audit controls that he or she designed and implemented?

The Nature of Operational Auditing

Just as a financial statement audit was described in Chapter 1 as a special application of the scientific method of inquiry, so too is an operational audit a special application of the scientific method. The objectives of internal and independent auditors differ, but the logic underlying their audit activities is similar.

In general, internal operational audits are conducted for any one or more of a half dozen or so different purposes:

- Verification.
- Appraisal of controls.
- Compliance.
- Protection of assets.
- Appraisal of performance.
- Recommendations for operating improvements.

Each is discussed next.

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12 Institute of Internal Auditors, Standards for the Professional Practice of Internal Auditing, Altamonte Springs, FL: The Institute of Internal Auditors, Inc, Section 1120.
Verification

Unless accurate and reliable, the data used by management to make decisions is likely to lead to poor decisions. Thus, operational audits can be designed to verify the accuracy and reliability of data used in internal management reports. The focus of verification reviews is not necessarily on responding to the results of inaccurate or unreliable data but, rather, on promoting accuracy and reliability. For example, a first-time operational audit performed by Orange County, Florida, internal auditors revealed that the four-county Economic Development Commission of Mid-Florida, funded largely by Florida state taxes, had overstated the number of new jobs by 119 percent, the number of jobs saved by 46 percent, and capital investment by 108 percent.13

Management information systems are intended to provide input for management decisions. Thus, the information system should generate the most relevant, or useful, data for a particular type of decision. As a result, verification reviews often are designed to evaluate the relevance and usefulness of data as well as accuracy and reliability.

Appraisal of Controls

Entities implement internal controls to assure compliance with management’s goals and objectives. The controls may take the form of policies, programs, and/or procedures. For example, a company may institute a program of recording and monitoring inventory spoilage in manufacturing plants as an operating control to achieve the organizational objective of reducing costs companywide. Although specific individual controls will vary, they all maintain a common framework.

<table>
<thead>
<tr>
<th>Framework</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. An objective.</td>
<td>1. Reduce inventory spoilage costs.</td>
</tr>
<tr>
<td>2. Techniques for determining compliance with objective.</td>
<td>2. Order raw materials just-in-time to minimize inventory levels and, therefore, control spoilage costs.</td>
</tr>
<tr>
<td>3. Action regarding noncompliance.</td>
<td>3. If spoilage costs increase, consider:</td>
</tr>
<tr>
<td></td>
<td>a. Reassessing the variables in order quantity model.</td>
</tr>
<tr>
<td></td>
<td>b. Alternative methods of inventory storage.</td>
</tr>
</tbody>
</table>

When appraising controls, the internal auditor’s purpose is to determine whether control activities are adequate. That is, are the controls satisfactory in light of the objectives for which they were designed? Appraisal of controls is a particularly significant operational audit activity because internal auditing itself is an organizational control designed to measure and evaluate the effectiveness of other controls.

Compliance

Controls are meaningless unless the controls are complied with. Thus, the purpose of an operational audit for compliance is to determine whether specific control policies, programs, or procedures are operating satisfactorily. The focus of

compliance reviews, however, is not necessarily on dealing with the potential results of noncompliance (for example, excess inventory spoilage), but on preventing further instances of noncompliance.

**Protection of Assets**
Closely related to compliance reviews are organizational audits designed to determine whether assets are properly accounted for and safeguarded from losses. Asset-protection reviews may be conducted both for liquid assets (for example, cash and marketable securities) and for nonliquid assets (for example, inventory and property, plant, and equipment), although the focus of each may differ, since liquid assets are much more susceptible to frauds. In either case, however, the internal auditor is concerned primarily with testing the effectiveness of those accounting, financial, and operating controls that were designed to account for and safeguard assets.

**Appraisal of Performance**
Employee performance is much more difficult to quantify than accounting or financial control compliance. As a result, interpretations and appraisals of employee performance can be tenuous at best. For example, employee performance is often influenced by variables other than extrinsic economic rewards, such as an employee’s job satisfaction and acceptance among peers. Interpreting the effect of these and other variables on an employee’s motivation to discharge his or her responsibilities adequately can be difficult, thereby suggesting that appraising employee performance also can be particularly difficult. Nevertheless, as a major organizational control over operational effectiveness, internal auditors are frequently called on to appraise employee performance. Employee performance reviews, however, can represent the one operational audit activity least consistent with the boundaries of an internal auditor’s professional expertise.

**Recommendations for Operating Improvements**
Each of an internal auditor’s operational audit activities should be designed to generate recommendations for improvements. When a reportable condition, error, fraud, or illegal act is discovered, the effects should be corrected and recommendations made to improve accountability. Although not itself an audit activity, recommending improvements is a significant by-product of the internal auditor’s professional role. Criticism alone is not enough. Internal auditors also should recommend improvements.

**Performing Operational Audits**
Although actual operational audits may vary depending on the circumstances, most include several basic characteristics, each of which is related to the scientific method of inquiry (introduced in Chapter 1) in Figure 19-10 and discussed in the following sections.

**Management Requests an Operational Audit**
Management may request operational audits for any one or more of the purposes discussed in the previous section. More specifically, however, management may request that the six reviews be applied to the organization’s:

- Computer facilities.
- Financial management practices.
FIGURE 19-10: *Relating the Scientific Method of Inquiry and Operational Audits*

<table>
<thead>
<tr>
<th>Scientific Method</th>
<th>Operational Audit Function</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Observe and recognize a problem.</td>
<td>Management requests an operational audit. Familiarization with the operational activity to be reviewed.</td>
</tr>
<tr>
<td>2. Formulate hypothesis.</td>
<td>Overall hypothesis: The accounting, financial, or operating control is operating properly and relevant to the control’s objective.</td>
</tr>
<tr>
<td>3. Gather relevant, verifiable evidence to test hypothesis.</td>
<td>Select appropriate operational audit procedures and gather sufficient competent evidential matter.</td>
</tr>
<tr>
<td>4. Evaluate evidence.</td>
<td>Evaluate evidential matter to determine if the hypothesis is supported, refuted, or inconclusive.</td>
</tr>
<tr>
<td>5. Develop conclusions.</td>
<td>Report to the appropriate organizational level.</td>
</tr>
</tbody>
</table>

- Quality control activities.
- Research and development efforts.
- Social responsibility.
- Financial statement accounts.

This list is by no means exhaustive. In fact, potential applications of internal audit activities are almost limitless.

**Familiarization**

Soon after an operational audit is assigned, an internal auditor and his or her staff should attempt to familiarize themselves with the specific operational activity to be reviewed. An operational audit should not be conducted in a vacuum; rather, to maximize efficiency, preliminary information should be gathered and the audit planned in advance. Several preliminary considerations for familiarization follow.

- Review internal audit working paper files and reports from prior operational audits.
- Discuss and coordinate the timing and scope of the review with the manager of the activity to be audited.
- Coordinate staff requirements with the director of internal auditing to assure that the operational audit can be completed on time.

**Formulate a Hypothesis**

Developing an overall hypothesis requires careful consideration of the objectives of the operational audit. For example, if the purpose is to appraise controls, the internal auditor should determine the type of control policies, programs, and procedures to be reviewed and the purpose for which the control was designed. The operational audit hypothesis is then stated in terms of whether the control is desirable and potentially effective under the circumstances.
Select Procedures and Gather Evidence

Operational audit procedures are selected in light of the overall hypothesis of the audit. Specific considerations in selecting procedures may include:

- The formality of the reviewed activity’s information system; an informal system may preclude the internal auditor from reviewing all relevant information.
- Considering whether the control is designed to provide overall reasonableness or detailed compliance; more detailed compliance usually requires more detailed audit work.
- Overt evidence of problems, such as employees who admit noncompliance with a prescribed control.

The internal auditor should attempt to gather the most appropriate evidence for the audit procedures selected. Evidence should be gathered in sufficient quantity to promote logical conclusions and should be of the highest quality available—for example, written documents are generally of higher quality (though sometimes less informative) than informal verbal comments.

Evaluate Evidence and Report Results

In auditing, evidence is the only basis for drawing conclusions. Thus, the evidence gathered should be evaluated objectively and in light of the overall hypothesis. In turn, audit conclusions should be communicated to appropriate levels of management and within a reasonable time period. Unlike audit reports for financial statement audits (Chapter 3), standardized internal audit reports are not common, since the reports are not intended for use by third parties. The form and content of an internal audit report is usually left to the discretion of the internal auditor.

Relating Internal and Independent Auditing

Although internal and independent auditors use roughly the same audit methods, they have different objectives when performing audits. The objective of internal auditing is to assist management and the board of directors concerning the activities reviewed, and the objective of “external” auditing is to express an opinion on the financial statements audited. In addition, internal and independent auditors serve the needs of different user groups. The needs of external users are not served by internal operational audits, and the needs of internal users are not served wholly by financial statement audits. Thus internal and independent auditing are separate and distinct.

However, despite these differences, there is a relationship between internal and independent auditing, as illustrated in Figure 19-11. Both groups of auditors rely on the same data. Also, internal users rely on both internal and independent auditors, and external users rely on independent auditors. Importantly, independent auditors can and often do rely on an internal auditor’s work when the internal audit function is effective. As a result, an organization’s internal audit function can have a significant effect on the nature, timing, and extent of audit procedures applied by an independent auditor in a financial statement audit. Statement on Auditing Standards No. 65, “The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements,” provides guidance on considering the work of internal auditors and on using internal auditors to provide direct assistance to the auditor.
Obtaining an Understanding of the Internal Audit Function

Under the second standard of field work (Chapter 2), an independent auditor obtains an understanding of an entity’s internal controls sufficient to plan the audit. Because internal auditors are responsible to monitor the performance of an entity’s controls, the auditor should obtain an understanding of the internal audit function sufficient to identify internal audit activities that are relevant to planning the audit. In obtaining an understanding, the independent auditor should make inquiries of management about the internal audit department’s:

- Organizational status within the entity.
- Adherence to professional standards.
- Audit plan, including the nature, timing, and extent of audit work.
- Access to records and whether there are limitations on the scope of their activities imposed by management.
- Charter, mission statement, or similar directive from management or the board of directors.

The auditor’s inquiries should be directed only toward those internal audit activities relevant to a financial statement audit. For example, the internal auditor’s role in operational audits about the timeliness of management’s decision-making process would not be relevant to the independent auditor, but the internal auditor’s role in implementing controls to safeguard assets would be relevant.

Assessing the Competence and Objectivity of Internal Auditors

The Codification of Statements on Auditing Standards states that achieving an organization’s control objectives “... depends on the competence and integrity of personnel, the independence of their assigned functions, and their understanding of the prescribed procedures.” Consistent with this language, SAS No. 65 requires that independent auditors review the competence and objectivity of internal auditors before their work is relied on. Competence can be reviewed by considering, for example:

- The internal auditor’s educational level, professional experience, professional certification, and continuing education;
- Audit policies, programs, and procedures;
- Practices for assigning internal auditors;
- Supervision and review of internal auditor’s work; and
• The quality of working paper documentation, reports, and recommendations.

Objectivity, in turn, can be reviewed by considering the organizational level to which internal auditors report and policies used to maintain objectivity about the areas audited. As discussed earlier, objectivity and organizational status are closely related to an internal auditor’s independence. Internal auditors cannot be considered independent from organizational levels at or above those to which they report. Thus, independent auditors cannot rely on internal audit work performed for organizational levels at or above those to which an internal auditor reports—the internal auditor’s objectivity and independence would be suspect. For example, assuming competence and objectivity, an independent auditor may request that an internal auditor examine additions to property, plant, and equipment, thereby reducing the time required by an independent auditor to examine the property, plant, and equipment account.

**Effect of the Internal Auditors’ Work on the Audit**

The effectiveness of an organization’s internal audit function is one among a series of variables considered by an independent auditor when planning and conducting a financial statement audit. Other variables, discussed more fully in earlier chapters, include materiality and audit risk. Independent auditors consider these other variables to determine their effect on the scope of a financial statement audit. Importantly, the scope of an independent audit can be reduced if an organization’s internal audit function is effective. Thus, the effectiveness of an entity’s internal audit function and the scope of an independent audit are inversely related: As the effectiveness of internal auditing increases, the scope of an independent audit can decrease.

In practice, independent auditors rely on internal auditors in addressing three issues relevant to a financial statement audit:

• Understanding internal control.
• Assessing risk.
• Performing substantive procedures.

**Understanding Internal Control** Procedures performed by internal auditors may provide information relevant to the independent auditor’s assessment of control risk, since a primary purpose of internal auditing is to monitor an entity’s control activities. For example, assuming they are competent and objective, the internal auditor’s flowcharts of an entity’s accounting system could be used to obtain information about the design of related policies and procedures, thereby reducing the time required by an independent auditor to assess control risk.

**Assessing Risk** As discussed in Chapter 2, the independent auditor assesses risk at both the financial statement level and the account balance level, and the effectiveness of an entity’s internal audit function may affect both. For example, at the financial statement level, if the internal auditor’s plan includes relevant audit work at various locations throughout the country or around the world, the independent auditor may coordinate his or her work with the internal auditors, thereby reducing the number of locations at which the independent auditor would otherwise need to perform auditing procedures. At the account balance level, the scope of the internal audit function may include tests of controls for selected financial statement assertions, such as completeness for sales and receivables, thereby reducing the scope of the independent auditor’s tests.
Performing Substantive Tests  Many internal audit departments also perform substantive tests of details that, as discussed in Chapter 4, are the independent auditor’s primary means of detecting material misstatements in financial statement accounts. As a result, some procedures performed by internal auditors may provide the independent auditor with direct evidence about material misstatements. For example, as part of their normal audit function, internal auditors may confirm accounts receivable and observe the counting of physical inventories, two procedures typically performed by the independent auditor. Assuming the internal audit function is competent and objective, substantive tests performed by internal auditors may provide important evidence to the independent auditor in restricting detection risk for some financial statement assertions.

Evaluating an Internal Auditor’s Work

Although independent auditors often rely on the work of competent and objective internal auditors, the responsibility to report on the financial statements rests solely with the independent auditor. Unlike opinions based partly on the report of another independent auditor, discussed in Chapter 3, the responsibility for an audit cannot be shared with the internal auditor. Even though internal auditors may provide information for the independent auditor’s judgments about the assessment of control risk and inherent risk (Chapter 6), about the materiality of misstatements, and about the sufficiency of tests performed, those judgments are the independent auditor’s responsibility.

Despite reviews of an internal auditor’s competence and objectivity, an independent auditor should not accept an internal auditor’s work “on blind faith.” The internal auditor’s work should be evaluated before it is fully relied on. An internal auditor’s documented evidence should be examined on a test basis to provide an independent auditor with a basis for judging the adequacy and appropriateness of:

- The scope of internal audit work.
- Audit programs.
- Working paper documentation.
- Conclusions reached.
- Any reports prepared.

In addition, the independent auditor should perform tests of some of the internal auditor’s work. For example, if an internal auditor examined evidence in support of 25 additions to property, plant, and equipment, an independent auditor may examine evidence in support of a small number of the same additions, comparing the results with those reached by the internal auditor.

KEY TERMS

Compliance Auditing
- Economy and efficiency audits 6
- Financial audits 5
- Government auditing standards 5
- Performance audits 6

Program audits 6
Single Audit Act 10

Internal Auditing
- Operational auditing 15
REFERENCES

Compliance Auditing

Professional Standards:
SAS No. 54, “Illegal Acts by Clients” (AU Sec. 317).
SAS No. 74, “Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance” (AU Sec. 801).

Articles, Books:

Internal Auditing

Professional Standards:
SAS No. 55, “Consideration of the Internal Control in a Financial Statement Audit” (AU Sec. 319).
SAS No. 78, “Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55.”
SIAS (Statement on Internal Auditing Standards) No. 1, “Control: Concepts and Responsibilities.”
SIAS No. 2, “Communicating Results.”
SIAS No. 3, “Deterrence, Detection, Investigation, and Reporting of Fraud.”
SIAS No. 4, “Quality Assurance.”
SIAS No. 5, “Internal Auditors’ Relationships with Independent Outside Auditors.”
SIAS No. 6, “Audit Working Papers.”
SIAS No. 8, “Analytical Auditing Procedures.”
SIAS No. 9, “Risk Assessment.”
SIAS No. 10, “Evaluating the Accomplishment of Established Objectives and Goals for Operations or Programs.”
SIAS No. 12, “Planning the Audit Assignment.”
SIAS No. 15, “Supervision.”
SIAS No. 17, “Assessment of Performance of External Auditors.”

Articles, Books:

QUESTIONS

**Compliance Auditing**
1. Distinguish between financial statement auditing, compliance auditing, and internal auditing.
2. What three responsibilities do generally accepted auditing standards impose in compliance audits of governmental entities?
3. What is the auditor’s responsibility under generally accepted auditing standards to detect direct and material violations of laws and regulations?
4. What types of audits and attestations are addressed in the GAO’s *Government Auditing Standards*?
5. In reporting on compliance with laws and regulations, what does the GAO’s Government Auditing Standards require an auditor to report?
6. To whom are reports on compliance with laws and regulations typically distributed?
7. In what ways does reporting on internal control in an audit under the GAO’s *Government Auditing Standards* differ from reporting on internal control under SAS No. 60, “Communication of Internal Control Related Matters Noted in an Audit,” the statement governing reports under generally accepted auditing standards?
8. Which governmental entities are required to have a single audit?
9. What responsibilities are imposed on the auditor by the Single Audit Act and by OMB Circular A-128, “Audits of State and Local Governments”?
10. Identify the general and specific laws and regulations addressed in the Single Audit Act and OMB Circular A-133, “Audits of States, Local Governments, and Non-profit Organizations.”

**Internal Auditing**
11. Cite several significant events in the development of contemporary internal auditing in the United States.
12. Identify several major internal audit activities.
13. What are the primary sources of an internal auditor’s independence?
14. Outline the overall approach to an internal operational audit. How is this approach similar to other types of audit activities?
15. How are internal auditing and independent auditing related?
17. What information should the independent auditor consider when assessing the competence of the internal auditors?

18. What information should the independent auditor consider when assessing the objectivity of the internal auditors?

19. The work of internal auditors may affect the nature, timing, and extent of a financial statement audit. What audit areas are most likely to be affected by the work of the internal auditors?

20. When evaluating the effectiveness of an internal auditor’s work, what should the independent auditor consider about the internal auditor?

MULTIPLE CHOICE QUESTIONS

Compliance Auditing

1. A governmental auditor is performing an audit of the City of Pawtucket, Rhode Island. The auditor’s objective is to determine whether the City’s financial statements are presented fairly in all material respects and whether the City has complied with laws and regulations that may have a bearing on the financial statements. This is an example of which of the following engagements?
   a. Financial audit
   b. Program audit
   c. Attestation engagement
   d. Economy and efficiency audit

2. Performance audits include:
   a. Financial statement audits.
   b. Attestation engagements.
   c. Program audits.
   d. Compliance audits.

3. Reports on compliance with laws and regulations provide:
   a. Assurance on the results of tests for noncompliance.
   b. Representations that management is responsible for compliance with laws and regulations.
   c. Excerpts of grant and loan agreements.
   d. Negative assurance on financial statements.

4. Which of the following procedures is not appropriate for identifying laws and regulations that management may have overlooked?
   a. Discussing laws and regulations with the entity’s chief financial officer, legal counsel, or grant administrators.
   b. Reviewing grant and loan agreements.
   c. Reviewing information about compliance requirements available from state societies of CPAs.
   d. Confirming violations with agencies granting federal financial assistance to the entity.

5. Which of the following procedures would likely lend insight into the risk of material misstatement arising from violations of laws and regulations?
   a. Confirming receivables balances with debtors.
   b. Observing the procedures used by grant administrators to detect violations of laws and regulations.
   c. Considering the competence of client personnel responsible for complying with applicable laws and regulations.
   d. Interviewing recipients of grant funds disbursed by the entity.
6. In a financial audit under the GAO’s *Government Auditing Standards*, an auditor is not responsible for which of the following?
   a. Determining whether the financial statements present fairly financial position, results of operations, and cash flows in conformity with GAAP.
   b. Planning the audit with due professional care.
   c. Determining whether the entity has complied with applicable laws and regulations.
   d. Determining whether the entity is acquiring, protecting, and using resources economically and efficiently.

7. In reporting on compliance with laws and regulations under the GAO’s *Government Auditing Standards*, which of the following procedures is not appropriate?
   a. Providing positive assurance on items tested.
   b. Providing a description of material instances of noncompliance.
   c. Providing an opinion on management’s responsibility for instances of noncompliance.
   d. Providing negative assurance on items not specifically tested.

8. In reporting on internal control, the GAO’s *Government Auditing Standards* imposes more responsibility on an auditor than SAS No. 60, “Communication of Internal Control Related Matters Noted in an Audit,” the standard under generally accepted auditing standards. How do the GAO’s standards differ from SAS No. 60?
   a. SAS No. 60 does not require communication of reportable conditions.
   b. A report under the GAO’s standards describes deficiencies in internal control that are not significant enough to be considered reportable conditions under SAS No. 60.
   c. SAS No. 60 requires that the auditor identify internal control categories.
   d. The GAO’s standards require a report on compliance with laws and regulations.

9. The *Single Audit Act* evolved because:
   a. The GAO was overburdened with grant audits.
   b. Congress preferred that governmental auditors emphasize grant contracts rather than financial statements.
   c. There was a need for audits that de-emphasized grants that were immaterial to the financial statements.
   d. Grant-by-grant audits were not cost effective.

10. Under the *Single Audit Act*, specific requirements include:
    a. Political activity.
    b. Federal financial reports.
    c. Eligibility.
    d. Administrative requirements.

**Internal Auditing**

11. The independence of an internal auditing department will most likely be assured if it reports to the:
    a. President.
    b. Controller.
    c. Treasurer.
    d. Board of directors.

12. A major responsibility of internal auditing is to:
    a. Install sound accounting, financial, and operating controls at reasonable cost.
    b. Determine the extent of compliance with established policies, plans, and procedures.
    c. Account for the company’s assets and safeguard them from losses.
    d. Develop reliable management data.
13. In comparison to the independent auditor, an internal auditor is more likely to be concerned with:
   a. Legal and regulatory compliance.
   b. Cost accounting procedures.
   c. Operational auditing.
   d. Internal control.

14. Taylor Sales Corp. maintains a large full-time internal audit staff that reports directly to the chief accountant. Audit reports prepared by the internal auditors indicate that the system is functioning as it should and that the accounting records are reliable. The independent auditor will probably:
   a. Eliminate tests of controls.
   b. Increase the depth of the assessment of control risk.
   c. Avoid duplicating the work performed by the internal audit staff.
   d. Place limited reliance on the work performed by the internal audit staff.

15. When an independent auditor decides that the work performed by internal auditors may have a bearing on the nature, timing, and extent of planned audit procedures, the independent auditor should evaluate the objectivity of the internal auditors. Relative to objectivity, the independent auditor should:
   a. Consider the organizational level to which internal auditors report.
   b. Review the quality control program in effect for the internal audit staff.
   c. Examine the quality of the internal audit reports.
   d. Consider the qualifications of the internal audit staff.

16. Operational audits generally have been performed by internal auditors but may be performed by independent accountants. A primary purpose of an operational audit is to provide:
   a. A means of assuring that internal controls are functioning as planned.
   b. Aid to the independent auditor, who is auditing the financial statements.
   c. The results of internal examinations of financial and accounting matters to an entity’s top-level management.
   d. A measure of management performance in meeting organizational goals.

17. When an independent auditor relies on the work of an internal auditor, he or she should examine the internal auditor’s work to provide a basis for judging the:
   a. Qualifications of the internal auditor.
   b. Integrity of the internal auditor.
   c. Scope of the internal auditor’s work.
   d. Importance of the internal audit function to the board of directors’ audit committee.

18. Independent auditors are unlikely to rely on internal auditors for:
   a. Assessing risk.
   b. Performing substantive procedures.
   c. Understanding internal control.
   d. Drafting audit reports.

19. To best understand a company’s internal audit department, the independent auditor could:
   a. Review standards published by the Institute of Internal Auditors.
   b. Make inquiries of the audit committee of the board of directors.
   c. Review reports the internal audit department has issued.
   d. Make inquiries of management.
20. Internal auditors should be:
   a. Impartial.
   b. Advocates for management.
   c. Employed by the board of directors.
   d. Certified.

PROBLEMS AND DISCUSSION CASES

Compliance Auditing

19-1 Responsibility for Tax Assessments in a Special Revenue Fund

Jayne Phillips, CPA, has been engaged by the town council of Granger to perform an audit of the town’s June 30, 2007, financial statements in accordance with generally accepted auditing standards. By referendum, the town in November 2006 approved a special tax assessment to be used in constructing an addition to the local high school and in purchasing temporary free-standing classrooms for the middle school. The referendum called for the assessment to be accounted for in a special revenue fund.

Required: What is Phillips’s responsibility regarding the accounting for the special tax assessment?

19-2 Responsibilities Under GAAS and Government Auditing Standards

The City of Central Falls has engaged Robert Cohen, CPA, to audit the June 30, 2007, financial statements of the City’s Water Department under the GAO’s Government Auditing Standards. Cohen’s report will be used by the City and by the state’s legislative auditors who, under laws passed by the General Assembly, will perform an audit of the City for the fiscal year ended June 30, 2007. The Water Department generates revenue from two sources: a water use tax and a budgetary allocation from the City’s general fund.

Required:
1. How does Cohen’s responsibility in auditing the Water Department’s financial statements under the GAO’s Government Auditing Standards differ from his responsibility under generally accepted auditing standards?
2. In reporting on the Water Department’s compliance with laws and regulations, what specifically must Cohen report about transactions tested during the audit?

19-3 Reporting on Internal Control Under Government Auditing Standards

Michael Cunningham, CPA, is preparing a report on internal control in conjunction with an audit of the City of Warwick’s June 30, 2007, financial statements. The audit is being conducted in accordance with the GAO’s Government Auditing Standards. The City of Warwick has two transaction cycles: a revenue/receipt cycle and an expenditure/disbursement cycle. During the engagement, Cunningham noted one reportable condition: Policies and procedures have not been implemented to subject material purchases to competitive bids. An experienced auditor, Cunningham has frequently reported on internal control under SAS No. 60, “Communication of Internal Control Related Matters Noted in an Audit,” but has never before performed an audit for a governmental entity.

Required:
1. How does Cunningham’s responsibility for reporting on internal control under the GAO’s Government Auditing Standards differ from his responsibility under SAS No. 60?
2. From the facts, draft a report on internal control.

19-4 The Single Audit Act and OMB Circular A-133

Owing to a small federal grant from the Department of Housing and Urban Development (HUD) to the Town of Stillman, Nadine Gordimer, CPA, has performed grant audits for the
town in each of the past five years. The town has received no other federal financial assistance. However, in 2007, the town applied for and received an additional one-year HUD grant for the minimum amount subjecting Stillman to the requirements of the Single Audit Act and OMB Circular A-133, “Audits of States, Local Governments, and Other Non-profit Organizations.” The grant funds were received and disbursed for low-income housing refurbishing in 2007. Not having performed a single audit previously, Gordimer seeks your advice.

**Required:**
1. Does the HUD grant to the Town of Stillman represent a major program or a nonmajor program under the Single Audit Act?
2. Explain the Town’s reporting responsibilities under the Single Audit Act.

### 19-5 Governmental Financial Audits and Financial Statement Audits

Wil Stevens is an executive vice president of a major automobile manufacturing company. Recently, Stevens was elected mayor of Detroit. Prior to assuming office, he calls on you, his independent auditor, for advice. He asks you to explain the major similarities and differences between a financial audit for a large city and a financial statement opinion audit for an industrial corporation.

**Required:** Describe the major similarities and differences between a governmental financial audit and a financial statement opinion audit of a business enterprise.

### 19-6 Auditing a Federally Funded Housing Allowance Program

A public accounting firm has been engaged to perform the audit of a local, federally funded Housing Allowance Program. The objective of the program is to increase the housing standards of Agana County through subsidized rent payments. The program, however, has been criticized by local authorities for failing to achieve significant results during its two years of existence. You have been assigned to plan an audit.

**Required:**
1. What matters should the firm take into consideration when planning the Housing Allowance engagement?
2. Apply the scientific method of inquiry (Chapter 1) to the engagement, giving examples of procedures and measurement criteria the firm should deem appropriate.

### 19-7 Auditing a Department of Education School Breakfast Program

As a GAO auditor, you have been assigned to perform an audit of a Department of Education School Breakfast Program. The Department had instructed all schools to order commodities in economical institutional-size packages to the extent possible. In 8 of the 22 schools covered by the review, you have found purchases in small-size packages. You estimate that additional costs total $10,000 per month, per school. Considering the escalation in food prices, it was evident that bulk purchasing was essential due to favorable quantity discounts. Department of Education officials stated that although bulk purchases were encouraged, they were not mandated.

**Required:**
1. What type of audit is contemplated by the description above? Explain.
2. Draft a paragraph summarizing the recommendations you would include in a report to the Department of Education.

### Internal Auditing

### 19-8 Developing a New Internal Audit Department

Bird Machine Company is considering developing an internal audit department. A few years ago, the company began an expansion program that included acquiring new busi-
nesses, some of which are located quite far from the home office. Bird Machine retained the prior managements after most acquisitions and expects to continue to do so. The corporate organization is decentralized, and the parent company (Bird Machine) sets general policies. Division and subsidiary managements are quite autonomous—their performance is measured against budgets and return-on-investment targets established at the beginning of each year. The separate units of Bird Machine manufacture and market their own products. Current sales volume is $150,000,000.

Bird Machine has been audited by the public accounting firm in which you are a manager. You have supervised the audit for the past three years and have now been asked by Bird Machine Company to prepare a report on activities that could be assumed by an internal audit department.

**Required:**
1. Draft a report that describes:
   a. The objectives of independent and internal auditors.
   b. The types of audits an internal audit department might be expected to perform.
   c. The relationship between the internal and the independent auditor.
2. The company has offered you the position of director of internal auditing. Describe changes in your audit philosophy and in your relationship to Bird Machine’s management if you were to take the job.

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**19-9 Why Both Internal Auditing and a Financial Statement Audit?**
Anton Rivlen, a local real estate broker, has been appointed to the board of directors of Destran Corporation. At a recent board meeting, Rivlen discovered two planned expenditures for auditing: The controller’s budget included an amount for internal auditing, and the treasurer’s budget included an amount for the 2007 financial statement audit by a major public accounting firm.

Rivlen didn’t understand the need for two different expenditures for auditing. Since the fee for the financial statement audit was less than the cost of internal auditing, she proposed eliminating the internal audit function.

**Required:**
1. Explain to Rivlen the purposes served by internal auditing and by a financial statement audit.
2. What benefits does the public accounting firm performing an audit derive from internal auditing?

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**19-10 An Internal Auditor’s Objectivity and Independence**
Many internal audit departments report to a level of authority below either the board of directors or the chief executive officer, raising some doubt about the internal auditor’s objectivity and independence. The organization chart on the following page is an example.

**Required:** Cite the advantages and disadvantages to the internal audit department of the responsibilities depicted in the chart.

(IIA Adapted)

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**19-11 Initial Steps in Establishing an Internal Audit Function**
A consulting professional in a public accounting firm, you have been engaged to establish an internal audit function in Newman Crosby Corporation, a commercial manufacturer of fabricated steel fittings that employs thousands in four Midwest states. The company markets to wholesale, manufacturing, and warehousing businesses in the United States and abroad.

**Required:** Describe the initial steps you would take to familiarize yourself with the company before establishing the internal audit function.
Over the past several years, Hobble, Inc., has expanded, diversified, and grown both in sales and in profit. Two years ago Hobble’s management established an internal audit department that is responsible for evaluating and recommending modifications in control activities, reviewing operations to promote efficiency and economy, and conducting special inquiries at management’s direction.

As in prior years, Hobble, Inc., has engaged Plautz & Associates LLP as independent auditors for the current year, 2007. The partner in charge of the Hobble audit has made an appointment with the manager of Hobble’s internal audit department to discuss the progress of the department, including new personnel and new activities. The partner needs this information to plan the scope of the audit and to determine the amount of assistance that will be needed from the internal audit department.
**Required:** The scope of an independent audit can be modified if a competent internal audit department exists. What characteristics of Hobble’s internal audit department and of its work should Plautz & Associates evaluate when establishing the scope of the financial statement audit?

(IMA Adapted)

19-13 Criticizing an Internal Auditor’s Objectivity

The internal auditing department of a large service entity is responsible to the controller who, in turn, is responsible to the president. As part of the internal audit responsibility, regular audits are performed of payroll, general accounting, accounts receivable, and accounts payable. Because these activities also report to the controller, criticism is frequently made that the internal auditor cannot be objective.

**Required:** Following are two solutions that might eliminate the criticism. Describe briefly the advantages and disadvantages of each.

1. The internal auditing department could send audit reports about activities under the controller’s supervision directly to the president.
2. The director of internal auditing could discuss the organizational problem with the independent auditors and ask them to make a recommendation that would eliminate the criticism.

19-14 Stock Shortages and Internal Auditing

During the audit of purchasing and inventory operations, an internal auditor discovers that significant quantities of purchased materials are neither in stock nor accounted for. Stock records, controlled by the warehouse supervisor, do not reflect shortages and the inventory reports appear to have been altered. The internal auditor suspects that the warehouse supervisor altered the reports, since he has the greatest opportunity to remove materials for personal gain.

The auditor notifies the department manager and together they confront the suspected supervisor. The supervisor offers no explanation for the shortages and denies any wrongdoing. The department manager immediately suspends the supervisor, pending further investigation, and informs the warehouse employees. Since no adequate explanation for the shortages was obtained, the auditor contacts security for assistance.

**Required:** List actions the auditor and the department manager might take that could hinder a successful investigation and could subject the company to legal proceedings. Briefly discuss the possible adverse effect of each.

(IIA Adapted)

19-15 Coordinating Internal and External Auditors

The agenda of a forthcoming meeting of the audit committee of a board of directors indicates that you are to discuss coordination between independent and internal auditors.

**Required:**

1. What are the advantages of coordination between independent and internal auditors?
2. What are the essential ingredients to establishing effective coordination between independent and internal auditors?
**RESEARCH PROJECTS**

1. **One Audit, Several Reports**

Reports on a nongovernmental entity’s audited financial statements capture an independent auditor’s opinion on financial position, results of operations, and cash flows in a single critical phrase known well to the users of financial statements: “...present fairly in all material respects...” (Chapter 3). One audit, one audit report. But in the array of reports on a state or local governmental entity’s single audit, auditors report on a variety of matters crucial to compliance with the Single Audit Act and with the Office of Management and Budget (OMB) Circular A-133, among them the entity’s general purpose financial statements, compliance with laws and regulations, and participation in federal financial assistance programs. One audit, several reports.

**Required:** Select a single audit report issued for a state or local governmental unit from a source such as a governmental unit near you. Draft a report that:

1. Interprets the meaning of each paragraph (that is, why do you think professional standards require the auditor to say what he or she is saying?) and indicates the conclusions reached by the auditor (that is, what is the critical phrase users anchor on?) in each of the five reports introduced in this chapter that are applicable to the reporting entity:
   a. Report on compliance with general requirements.
   b. Report on major program compliance with specific requirements.
   c. Report on nonmajor program compliance with specific requirements.
   d. Report on the schedule of federal financial assistance.
   e. Report on internal controls over federal financial assistance.

2. Explains why you think that the single audit report you selected may not include one or more of the reports previously listed.

2. **Internal Auditing in Selected Industries**

Just as financial statement auditing varies by industry, so too does internal auditing, in part because the risks vary from industry to industry. For example, the risks related to accounting estimates are quite different in the airline industry (that is, frequent-flier liabilities), the construction industry (that is, percentage of completion), and the health care industry (that is, third-party reimbursements). However, although the professional literature is replete with guidance about financial statement audits in several major industries—for example, the AICPA’s Audit and Accounting Guides—the literature is less forthcoming about industry-specific operational auditing.

**Required:** Select an AICPA Audit & Accounting Guide for an industry that interests you (for example, airlines, casinos, construction contractors, finance companies, property and liability insurance companies, providers of health care) and a recent annual report for a publicly traded company within the industry. Draft a report that:

1. Discusses how a public accounting firm could use the company’s internal audit department to accomplish the audit of audit and accounting issues identified within the Audit Guide.
2. Discusses the company’s internal audit department using information accessed from:
   a. The company’s Web page, or
   b. The company directly (a mailing address and telephone number are typically included in an annual report).

Interactive quizzes are available as a student learning resource at [http://ricchiute.swlearning.com](http://ricchiute.swlearning.com)