PART I

Background of Federal Auditing

1 BACKGROUND OF FEDERAL AUDITING

EVOLUTION, STANDARD SETTERS, RESPONSIBILITIES, AUDIT TYPES

The financial impact of government in America is enormous. The economic impact of the federal government alone overshadows any state, local government, or private sector entity, not to mention the governments of other countries. The United States federal government employs millions, owns billions, and spends trillions each year. For fiscal year 2006 (ending at midnight on September 30, 2006), the receipts of the federal government are budgeted at $2.177 trillion; federal outlays are budgeted at $2.539 trillion. And these are merely the "budgeted" amounts. Not included are the "off-budget" expenditures and contingent liabilities of independent agencies, government-sponsored enterprises, government corporations, and other federal entities that comprise additional trillions of dollars.

EVOLUTION OF GOVERNMENTAL AUDITING

The roots of governmental auditing can be traced back to the conception of the Constitution. The following sections will trace and summarize highlights in the evolution of governmental auditing.

Federal Financial Management: Frustrations and Discontent

Authors of the Constitution vested responsibility for the financial affairs of the federal government in the legislative branch, giving Congress exclusive power to levy and collect taxes, borrow on the credit of the United States, and coin money. Very early in 1789, with the passage of the Treasury Act, Congress provided for an auditor and a comptroller in the Department of the Treasury. At the same time, Congress placed reliance on the discretion of departmental accounting officers to enforce legislative provisions related to expenditures of public funds. The next 150 years were overshadowed by the frustration of part-time Congresses, with few senators and representatives, and minimal professional assistance. The legislative history of the times, as recorded in congressional committee hearings and enacted financial management legislation, documented discontent with inconsistencies in executive branch accounting practices, the credibility of financial reporting by agencies, and repeated lapses in controls over federal financial reporting.[1]

One hundred years later, by the Dockery Act of 1894, Congress attempted to streamline the federal financial system and formally institute fiscal reforms: an Office of Comptroller of the Treasury was created. Six auditors were assigned depart-

[1] *U.S. Senate, Committee on Government Operations,* ***Financial Management in the Federal Government: A Comprehensive Analysis of Existing and Proposed Legislation including Financial Management Improvements Made on a Government-wide Basis****, Washington, DC, 1961.*

mental audit responsibilities and were required to certify to the balances of agency accounts that underwent mandated examinations; and individual federal departments were charged with the responsibility to make administrative examinations of their accounts before submission to the auditors. Because the comptroller and auditors were officials in the executive branch, congressional frustration continued over the legality and propriety of expenditures by the executive branch.

With the Budget and Accounting Act of 1921, Congress instituted numerous financial management improvements, many of which remain to this day. Two among several, which are discussed later in this chapter and in other chapters, were the establishment of the Bureau of Budget in the Department of Treasury and the General Accounting Office in the legislative branch, with government-wide responsibilities for accounting and auditing. Throughout the twentieth century, congressional discontent and frustration over the inadequate methods of federal financial practices continued. In fact, in the decade of the 1990s alone, Congress passed more financial management legislation than in any decade in the country's history.

Auditing and Government

The practice of auditing dates back millennia; its roots are more in the public sector than in the private sector. Interestingly, these earlier audits were not merely fiscal or financial in nature, but often addressed broader accountability, stewardship of assets, and legal compliance with respect to the receipts, disbursements, and uses of funds. Frequently, the sovereign or government's assets, administered by agents, were the impetus for periodic audits. In America, however, it was the government's treasury and finances that were of concern to citizens and legislators. The priorities of colonial auditors closely paralleled those of today: conformance to budgets, completeness of reported receipts, appropriateness of expenditures, application or use of tax monies, and compliance with laws.[2]

Over the course of two centuries, the practices and ongoing problems of auditing perplexed many, confounded multitudes, and seemed to be the source of never-ending legal suits, trials, and judgments. Not the federal government, the courts, the public, or the accounting profession had definitive views on what constituted an acceptable audit. Many attempts were made to set auditing standards and mandate specific auditing practices, and generally, these promulgations were appropriate and applied. But in many instances, when it was not possible to anticipate or provide for all of the circumstances and conditions that might be encountered in an audit, legislators, regulators, and standard setters told the auditor to "use judgment." At times, the judgment exercised was in conflict with or challenged by regulators, recipients, and other users of auditor reports. This was evident in the print and electronic media coverage of the 1990s and early 2000s on numerous accounting, financial, and audit inadequacies. In many instances, the contested audit practices involved publicly traded corporations. Reviews of court dockets and governmental administrative law courts disclose similar disputes involving the federal and other governments.

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[2] *William Holmes, Linda H. Kistler, and Louis S. Corsini,* ***Three Centuries of Accounting in Massachusetts*** *(New York: Arno Press, 1978).*

Auditing: Issues Continue

To this day, the auditing issues continue. What is an appropriate audit scope? What transactions should be audited, how many, and for which fiscal periods? What type of audit report should be issued? And, who says so? Editions of *The Accountant* document a contradiction of views. Consider the audit expectations of the 1880s:[3]

> *The auditor's task is compared to judge and jury; for some outstanding matters, estimation must be introduced; but the auditor should not indulge in forecasts or expressions of feeling; rather the auditor should adhere to only the facts—the hard, dry, realities.*

Of course, most people outside the accountancy profession do not subscribe to such a restricted scope for financial reporting and auditing. The audit determination of an entity's financial position, whether profits in the case of companies or fund balances in the case of governments, is replete with exercises of auditor judgment, which cannot be avoided. With the possible exception of the cash account balance, all balances in a financial statement are the product of some level of estimation, and even forecasting or projection. Clearly, adhering only to the facts— "the hard, dry, realities" —was never an option.

Independent accountants first attained visibility and national recognition through work in the governmental sector, a sector that generally lacked internal auditors. Teaming with progressive reformers and governmental "do-gooders" of the late 1800s, accounting practitioners highlighted the relationships between the corruption and inefficiency of government to the prevailing social ills of public sector governance. The absence of uniform accounting, minimal or inadequate financial reporting, and no requirement for periodic independent audits were significant contributors to the disclosed problems.[4]

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

Congress is cognizant of the need to clarify current guidance. As this book is being written, the House Government Reform Subcommittee on Government Management, Finance and Accountability is seeking ways to hold federal executives more accountable for their behavior. Representative Todd Russell Platts (R-Pa), subcommittee chairman, is holding hearings regarding how to continue to improve financial management in the federal government, and two of the writers of this book testified in the initial hearing held by Representative Platts. One area of emphasis is

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[3] ***The Accountant*** *was the professional periodical of the predecessor to the American Accounting Association, which today is the national organization of accounting professors in the United States.*

[4] *Gary John Previts and Barbara Dubis Merino,* ***A History of Accountancy in the United States,*** *(Columbus: Ohio State University Press, 1997), Chapter 5.*

the possible consolidation and, to the extent possible, simplification of the many federal financial management laws which have been passed over the years (a discussion of several of these laws appears in Chapter 2).

AUDITING THE FEDERAL GOVERNMENT: DEFINITION AND SCOPE

In the 1970s, the General Accounting Office (now, and hereon, the Government Accountability Office [GAO]) declared that audits of government needed to be different and more comprehensive and would require, if not entirely different audit standards, then the application of additional standards. These standards would address issues beyond the financial that are important to accountability in the federal government and by state and local governments, organizations, entities, and others involved with, or benefiting from, federal financial assistance. Thus, GAO's generally accepted *Government Auditing Standards* defined an *audit* as:

> *A term used to describe, not only work done by accountants in examining financial statements, but also work done in reviewing (1) compliance with laws and regulations, (2) economy and efficiency operations, and (3) effectiveness in achieving program results. The objective of such an examination includes an expression of the fairness of presentation of an entity's financial statements, but additionally a reporting, or an audit opinion if sufficient audit work was performed, on the nature of tests made and results of those tests with respect to an entity's system of internal controls and its compliance with laws and regulations and provisions of contract and grant agreements.*

In 2005, the focus of federal audits not only includes audits of an organization's financial statements, but may include concurrent assessments and attestations relating to an organization's performance, management, compliance with laws and regulations, and effectiveness of financial controls. The premise is that financial statement audits are important and will continue to be so, but audits of only financial data, as of a specific point in time, provide limited information as to whether an organization is economical or efficient, or if its operations even approach operational objectives defined in enabling legislation.

In the most recent edition of *Government Auditing Standards*, dated June 2003 (and effective for financial audits and attestation engagements on or after January 1, 2004, and for performance audits beginning on or after January 1, 2004), the current Comptroller General declared:

> *The concept of accountability for public resources is key to our nation's governing process and a critical element for a healthy democracy. Legislators, government officials, and the public want to know whether government services are being provided efficiently, effectively, economically, and in compliance with laws and regulations. They also want to know whether government programs are achieving their objectives and desired outcomes, and at what cost.*
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> *Government managers are accountable to legislative bodies and the public for their activities and related results. Government auditing is a key element in fulfilling the government's duty to be accountable to the people. Auditing allows those parties and other stakeholders to have confidence in the reported information on the results of programs or operations, as well as in related systems of internal control.*

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

FEDERAL AUDITING: WHO SETS THE STANDARDS?

Several organizations, both governmental and nongovernmental, by law or otherwise, have accrued significant statutory and other authority to prescribe standards for audits of federal agencies and of financial assistance provided to nonfederal entities through contracts, grants, and other agreements. In addition to laws of Congress establishing overall federal audit policy, other organizations, in and out of the federal government, have been instrumental in defining or impacting the scope of federal audits. These organizations include the American Institute of Certified Public Accountants (AICPA), GAO, the Office of Management and Budget (OMB), federal Inspectors General, the Securities and Exchange Commission (SEC), and the Public Company Accounting Oversight Board (PCAOB). These organizations are discussed in more detail in the following sections.

American Institute of Certified Public Accountants

At this time, the American Institute of Certified Public Accountants prescribes the generally accepted auditing standards (GAAS) that form the underlying foundation of the *Government Auditing Standards* used by all auditors when auditing any federal entity or recipient of federal financial assistance. Federal audits must satisfy the GAAS of the AICPA, which include general, fieldwork, and reporting standards, plus the AICPA's Statements on Auditing Standards (SAS).

The federal government's reliance on the AICPA's GAAS was noted in the initial issuance of *Government Auditing Standards* in 1972 and confirmed in its 1988, 1994, and 2003 revisions. In various sections, GAO stated that *Government Auditing Standards* incorporate all of the AICPA's fieldwork standards and reporting standards for audits and its Statements on Auditing Standards, unless the Comptroller General (who heads GAO) excludes such standards by formal announcement. To date, no Comptroller General has excluded any AICPA fieldwork, reporting standards, or Statement on Auditing Standards.

US Government Accountability Office

GAO, a federal agency in the legislative branch, was established by Congress in 1921 to be its audit, evaluation, and investigative arm. Its founding legislation, the Budget and Accounting Act, provided that a core responsibility of GAO was to investigate, at the seat of government or elsewhere, the *receipt*, *disbursement*, and *application* of public funds and to report annually to Congress on its work and its recommendations for needed legislation. GAO, completely independent of the executive branch and accountable only to Congress, is headed by the Comptroller General. The Comptroller General is appointed by the President and serves with the advice and consent of Congress for a 15-year term of office. The Comptroller General cannot be reappointed and can be removed from office only by way of formal impeachment proceedings by Congress.

In 1972, GAO issued the initial edition of the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, a title that was shortened in later editions to the *Government Auditing Standards* and is popularly referred to as the "yellow book," a reference to the cover's color. *Government Auditing Standards* states that audits involving public funds, federal, and other public monies, may not be limited to those financial statement audits annually made by CPAs and other auditors. The *Government Auditing Standards* govern audits of financial statements, assessments, and attestations with respect to an entity's compliance with laws and regulations and controls over financial reporting, as well as performance audits. In its *Government Auditing Standards*, GAO categorizes audits into three categories:[5]

1. Audits of financial statements at the conclusion of which the auditor provides an opinion
2. Financial related reviews for which the auditor might provide written assurances or attestations other than an audit opinion
3. Performance audits, the scopes of which encompass assessments of program effectiveness and results, economy and efficiency, internal control, and legal compliance

US Office of Management and Budget

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

In legislation such as the Chief Financial Officers Act of 1990 and other laws of the 1990s relating to financial management, Congress delegated responsibilities to OMB for federal accounting, auditing, systems oversight, and other financial management tasks. In exercising these responsibilities, OMB prescribed detailed policies and procedures to be applied in audits of federal executive branch departments, agencies, and their activities. The policy announcements appear in series referred to as OMB circulars and OMB bulletins, which are executive branch government-wide

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[5] *Unless otherwise noted, all references to, or citations of **Government Auditing Standards** or generally accepted government auditing standards relate to the guidance provided by GAO in the 2003 revision, **Government Auditing Standards**.*

regulations and directives detailing how federal departments and agencies are to implement laws of Congress.

OMB Circulars and Bulletins

OMB circulars are issued when the nature of a subject is of continuing effect and remains in force until rescinded or superceded. Circulars are identified by the prefix "A" and a number. For example, OMB Circular A-133, titled *Audits of States, Local Governments, and Non-Profit Organizations*, sets forth the federal audit policy, regulations, standards, and, in some instances, detailed audit procedures that must be employed when auditing recipients of federal financial assistance. OMB bulletins are used either when the nature of the subject requires a single or ad hoc action by federal departments and agencies or the issue is transitory in nature. The last two numerals of the fiscal year are used to indicate the annual series of bulletins and the sequential number of the specific subject matter. For example, OMB bulletins affecting federal audits: OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements* (issued on October 16, 2000, in the fiscal year 2001). Note that the federal government's fiscal year begins on October 1 of one calendar year and ends on September 30 of the succeeding calendar year.

Offices of Federal Inspectors General

Within the executive branch, there exist councils of federal Inspectors General established by presidential executive order to address integrity, economy, and effectiveness issues that transcend individual government agencies. A major function of these councils is to conduct intra-agency and intra-entity audit, inspection, and investigation projects to promote economy and efficiency in federal programs and operations, and to address government-wide issues of fraud, waste, and abuse more effectively. Collectively, Inspectors General develop audit and investigation policies, standards, and approaches, and issue mandatory audit guidance relating to audits of federal departments and agencies, as well as audits of nonfederal entities receiving varying forms of federal financial assistance.

The passage of the Inspector General Act of 1978 created, in the larger federal agencies, an Office of Inspector General with the responsibility to conduct and supervise audits and investigations of their respective agencies. The law provided that these Inspectors General would be appointed by the President and serve with the counsel and consent of Congress. Although Inspectors General may be removed from office by the President, the President must communicate the reason for the removal to Congress. In these agencies, the law required that there be an assistant Inspector General for auditing responsible for supervising performance of all auditing activities relating to the agency's programs and operations.

Securities and Exchange Commission and Public Company Accounting Oversight Board

The Sarbanes-Oxley law, passed by Congress in 2002, required changes to, and elimination of, some existing corporate governance practices of publicly listed companies. Additionally, this law created PCAOB, endowed with the authority to set reporting and auditing standards that must be used by registered public accounting firms in the preparation and issuance of audit reports related to financial statements of publicly traded companies. However, Sarbanes-Oxley requirements might soon be imposed on the federal financial management community, as the essence of the Act is already de facto federal financial management policy. For example:

- A government-wide federal policy relative to internal controls over financial reporting preceded and addressed the same issues as the Sarbanes-Oxley Act. This earlier internal controls policy arose as a result of actions taken over the years by: Congress in enacting earlier laws; OMB in its implementation of policy circulars and bulletins that prescribed regulations closely aligned with this new act; federal departments and agencies that for some years have been adapting systems of accounting, controls, financial management, and auditing guidance to the same subjects as the new act; and corrective and follow-up actions taken by federal agencies pursuant to recommendations of federal Inspectors General and GAO that are quite similar to those practices prescribed in the new act.
- Section 404 of the 2002 Sarbanes-Oxley Act requires that managements of public companies make assessments of the effectiveness of their internal controls based on a "suitable, recognized control framework established by a body of experts that followed due process procedures to develop the framework," specifically citing the *Internal Control–Integrated Framework* (the *Framework*) developed by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in 1992. Since the 1990s, OMB and GAO have encouraged adoption of the COSO *Framework* as the standard for federal agencies.

Thus, the essence or substance of these requirements by Sarbanes-Oxley would appear to be the same or quite similar to laws and federal policies of the 1990s directed toward improving the accounting and controls within federal agencies. GAO, in 2004 public forums, announced that as PCAOB promulgates auditing standards, GAO will refine its *Government Auditing Standards* to clarify any new guidance desired for federal audits.

TYPES OF GOVERNMENTAL AUDITS

When applied to corporate entities, the term *audit* is used primarily in reference to financial statement audits. Such audits are annually made of each required federal department and agency.[6] Additionally, however, during the course of a fiscal year, a far greater number of audits are made under other descriptors, such as *internal audits, functional audits, contract and grant audits,* and *performance audits*, to note a few. These special-focus audits are, for the most part, done by auditors of Inspectors General staffs, but a smaller number are also done by independent certified public accountants under contract to federal agencies. All of these audits are in conformance with GAO's *Government Auditing Standards*, applicable OMB circulars and

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

bulletins, and rules promulgated by Inspectors General either for their individual agency or collectively for the federal government. This section highlights a few such audits that are described with more detail in other chapters.

Financial Statement Audits

Financial statement audits are audits primarily concerned with providing reasonable assurance as to whether the annual financial statements of federal departments and agencies are presented fairly in all material respects in conformity with generally accepted accounting principles or *another comprehensive basis of accounting*.[7] For financial statement audits, an auditor would render an audit opinion or a disclaimer of opinion, depending on the results of the audit of the federal entity's financial statements. Such audits would have to conform to the *Government Auditing Standards* issued by GAO.

Nonstatement Financial Audits, Reviews, and Examinations

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

If the audit objective is to express an opinion on financial statements, selected chapters of the *Government Auditing Standards* for financial statement audits apply. Of the eight chapters of guidance in the "yellow book," three chapters apply directly to financial audits: Chapter 3, General Standards, applies to both financial and performance audits; Chapter 4, Fieldwork Standards for Financial Audits, and Chapter 5, Reporting Standards for Financial Audits, both pertain to financial audits.

Chapter 6, General, Fieldwork, and Reporting Standards for Attestation Engagements, pertains to attestation audits; Chapter 7, Fieldwork Standards for Performance Audits, and Chapter 8, Reporting Standards for Performance Audits, pertain to performance audits.

Performance Audits

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

> *An objective and systematic examination of evidence to provide an independent assessment of the performance and management of a program against objective crite-*

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[7] *Only three authoritative organizations may establish generally accepted accounting principles for governments: the Governmental Accounting Standards Board (GASB; for state and local governmental units), the Federal Accounting Standards Advisory Board (for federal departments, agencies, commissions, offices), and the Financial Accounting Standards Board (for state and local governmental units, but only on specific recognition by GASB).*

ria as well as assessments that provide a prospective focus or that synthesize information on best practices or cross-cutting issues.

Thus, GAO views a performance audit as one with audit objectives related to: assessing a program's effectiveness, program results, or achievements; relative economy and efficiency with which an activity is operated; internal or management controls; value-for-money audits; or an entity's compliance with laws and regulations. Because these audits may address a variety of objectives, it follows that they must be performed to different criteria. Each performance audit is unique with varying scopes of work and usually will result in a report in which the auditor sets forth the audit findings, conclusions, and recommendations. The Government Auditing Standards do not mandate a specific or described audit report for performance audits. Rather, they state that the form of a performance audit report should be appropriate for its intended use and be written or in some other retrievable form considering the users' needs, likely demand, and distribution.

Three chapters of the *Government Auditing Standards* apply directly to performance audits, whether such audits are performed by staffs of Inspectors General or independent accountants under contract to a federal agency: Chapter 3, General Standards, would apply to both financial and performance audits; Chapter 7, Fieldwork Standards for Performance Audits, and Chapter 8, Reporting Standards for Performance Audits, apply to performance audits.

In many instances, the objectives of performance audits are exclusively financial in nature, but can assess operational performance, compliance with laws and regulations, effectiveness of managerial controls, or other scopes, limited only by those requiring auditor assistance. The automatic application of performance auditing standards to financial audits, or vice versa, is not appropriate and may be prohibited by federal legislation.

Other Federal Audits

An almost inexhaustible variety of audits take place within the federal arena. Examples and summaries of some of the more common types are provided next.

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

Settlement or discharge audits of accountable officers have a long precedence in the United States, dating to the 17th century. At the conclusion of these earlier settlement audits, the auditor was required to read the account to an audit committee of peers who concluded on the reasonableness of the accounting, after which the report probably would be submitted to the governing court.[8] Settlement audits are not full-scope financial statement audits, but are more often an examination of the receipts,

[8] *William Holmes, Linda Kistler, and Louis Corsini,* ***Three Centuries of Accounting in Massachusetts.***

disbursements, and the propriety of the cutoff or "turnover" balance of an official's "account." In the federal government, there are several thousand *accountable officers* (e.g., collection officers, disbursing officers, cash custodians, and, in some cases, certifying officers).[9] GAO is authorized by law to perform a settlement audit of the final financial reporting of these executives.

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

Financial-related audits have several common features:

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

A description of some types of financial-related audits follows.

- *Payroll and personnel audits* are regularly performed, often premised on the fact that these expenditures are the most significant budgeted item by most governments. Often these costs—salaries, benefits, vacations, sick leave, overtime, and so on—can be 75 to 80%, or more, of a government's expenditures. The scope of such audits is directed toward assessing compliance with voluminous laws, regulations, and rules controlling appointments, hiring, promoting, paying, transferring, vacationing, terminating, and retiring government employees.
- *Contract and grant audits* are generally directed to assessing costs and/or performance by a government's contractors and grantees. With respect to costs, a common concern is compliance with the contract or grant financial budget and adherence to any allowable, unallowable, and indirect or overhead criteria. To a lesser extent, but still common, these audits will evaluate the performance of a contractor or grantee in relation to cost expended or accomplishment of predetermined objectives in relation to elapsed time budgets.
- *Property and fixed asset audits* are assessments of embedded or sunk costs of property and fixed assets in possession of governments or government contractors and grantees that are valued in the trillions of dollars. Such audits could cover all or a portion of the life cycle of these assets, with the audit scope addressing the adequacy of or compliance with a government's fixed as-

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

set policies, procedures, and practices over the purchase, receipt, accounting, storage, use, safeguarding, disposing, inventorying, and reporting of capital items such as buildings, equipment, furniture, fixtures, and, at times, infrastructure assets.

- *Systems audits,* in contrast to common perception, are not part of the annual financial statement audits. When an auditor opines, *"In our opinion, the financial statements present fairly, in all material respects…,"* this opinion provides minimal or no solace with respect to the adequacy or inadequacy of an entity's cost accounting, managerial competence, or effectiveness of control systems. A systems audit requires an audit scope specifically designed to assess the adequacy of account structure and data hierarchy, or the degree to which systems are accurately and timely capturing, compiling, and reporting financial and nonfinancial data relevant to the critical decisions being made by management or, increasingly, the extent, appropriateness, and effectiveness of automation.
- *Imprest/petty cash audits* are routinely made by governmental internal auditors of imprest fund and petty cash fund receipts, disbursements, and end-of-period balances. As is the case with corporate entities, these funds are widely utilized by governments to promote and simplify the cash disbursement process and reduce administrative costs. These audits typically are made on a surprise basis. The scope of such reviews includes an examination of support documents, tests for compliance with fund policies and procedures, assessing the appropriateness of fund balances, and determining the frequency of fund balance turnover.

AUDITING THE FEDERAL GOVERNMENT

Every day, thousands of professionals are involved with auditing and reporting on the activities of the federal government. Although many of these professionals are employed by the government, many others are employed by independent accounting firms to conduct audits under contracts from federal agencies. Little, though, has been published about these audits, which involve some of the largest professional audit organizations, nationally or internationally, in or out of government. Even less is taught about this branch of accountancy. A more complicating factor is that the form of federal financial statements, the applied federal accounting principles, and the mandated federal audit standards are not those applied to private sector or nonprofit sector entities or to state and local governmental units.

The practice of federal auditing encompasses those systems of controls, accounting, and financial reporting required by federal laws and government regulations that impact federal agencies and the hundreds of federal financial assistance programs in whatever form (e.g., federal subsidies, contracts and grants, loan and loan guarantees, settlement overruns and overhead disputes, and resolution of allowable, unallowable costs, and indirect cost issues). Knowledge of what federal financial executives must do to "keep the books straight" is information vital to all who do business with the federal government and all recipients benefiting from a federal assistance program. Knowing the issues of concern to federal financial managers, what will be audited, and how, provides insight into federal financial decisions pertaining to settlement of disagreements concerning legality or propriety of disbursed federal monies, settlement of disputes, and payment of claimed contract and grant costs.

The federal government, like other organizations and industries, has generated a jargon, a financial management language, of its own. Many of these terms, which permeate laws, policy, procedures, and practices that impact federal financial management, accounting, reporting, and auditing, are defined and illustrated in this book. An effort has been made to avoid altogether the journal entries and "T-accounts" so dear to accountants and auditors. The focus of this book, instead, is the professional and nonprofessional, in and out of government, academics and students, who have a need or desire to be better informed about their dealings with federal agencies and federal financial assistance programs. The book is divided into four parts to address interests of a diverse constituency that, at times, might well include legislators and their staffs, federal state and local governmental program managers and analysts, financial managers and accountants who must regularly undergo audit, and those doing business with the government.

Part I: Background of Federal Auditing

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

Chapter 1 highlights some of the history of auditing in the federal government, provides a description of auditing as practiced by federal agencies, and identifies the laws requiring the various types of audits conducted involving federal agency operations and financial assistance provided to nonfederal entities.

Chapter 2 identifies several laws that, over the past 200 years, have been the legal basis and precedent for audits historically and currently made of federal agencies, federal programs, and the government's contractors, grantees, borrowers, and those benefiting from any of many loan guarantee programs.

Chapter 3 describes the implications of the Sarbanes-Oxley Act of 2002. This act reordered the audit priorities of the past with respect to the controls over financial reporting of publicly listed companies. It mandated that managements must now assess the effectiveness of internal controls and have those controls independently audited; an audit report must be made of the effectiveness of controls in conjunction with the audit of an entity's financial statements.

Chapter 4 notes some shortcomings of past federal audits, discusses the roles and methods by which OMB, Inspectors General, and GAO oversee the practice of federal auditing, and describes organizations that audit the federal government and its national and international programs.

Part II: Federal Budgeting, Accounting, and Financial Statements

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

Chapter 5 describes, in general terms, the federal budget process and its participants, budgetary events requiring an accounting and reporting, plus an overview of the accounting life cycle of federal financial transactions.

Chapter 6 illustrates the form and content of several federal financial statements and describes the purpose or objective of each statement and the compilation process necessary to meet the advanced, accelerated federal reporting mandates.

Part III: Auditing in the Federal Government

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

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

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

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

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

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

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

Part IV: Nature of Selected Federal Audits

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

Chapter 13 provides, in summary, a description of a methodology for audits made pursuant to the Single Audit Act, identifying requirements of the Act and pertinent OMB regulations and guidance.

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

Chapter 15 highlights audit concerns and audit procedures that typically might be employed in an examination or audit of a federal agency's procurement and contracts function.

Chapter 16 highlights audit concerns and audit procedures that typically might be employed in an examination or audit of a federal agency's grants administration function.