United States Government Accountability Office

GAO

By the Comptroller General of the United States

December 2011

Government Auditing Standards

2011 Revision

U.S. Government Accountability Office
GAO 90 YEARS 1921-2011
ACCOUNTABILITY ★ INTEGRITY ★ RELIABILITY

GAO-12-331G

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2011 Revision

The 2011 revision of Government Auditing Standards supersedes the 2007 revision. The 2011 revision should be used by government auditors until further updates and revisions are made. An electronic version of this document can be accessed on GAO's Yellow Book Web page at http://www.gao.gov/yellowbook.

The 2011 revision of Government Auditing Standards is effective for financial audits and attestation engagements for periods ending on or after December 15, 2012, and for performance audits beginning on or after December 15, 2011. Early implementation is not permitted.

Revised on January 20, 2012, to correct a typo in paragraph 7.19.

U.S. Government Accountability Office

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Contents

Chapter 7 Reporting Standards for Performance Audits

Appendixes

Index

Abbreviations

AICPA	American Institute of Certified Public Accountants
AU-C	AICPA *Codification of Statements on Auditing Standards for Auditing*
AT	AICPA *Codification of Statements on Standards for Attestation Engagements*
CPA	certified public accountants
CPE	continuing professional education
COSO	Committee of Sponsoring Organizations of the Treadway Commission
ERISA	Employee Retirement Income Security Act
FISCAM	*Federal Information System Controls Audit Manual*
GAAP	generally accepted accounting principles
GAGAS	generally accepted government auditing standards
GAO	Government Accountability Office
IT	information technology
IAASB	International Auditing and Assurance Standards Board
IIA	Institute of Internal Auditors
ISAE	International Standards on Assurance Engagements
ISA	International Standards on Auditing
MD&A	management's discussion and analysis
OMB	Office of Management and Budget
PCAOB	Public Company Accounting Oversight Board
SAS	Statements on Auditing Standards
SSAE	Statements on Standards for Attestation Engagements

G A O
Accountability * Integrity * Reliability
Comptroller General
of the United States
United States Government Accountability Office
Washington, D.C. 20548

Audits provide essential accountability and transparency over government programs. Given the current challenges facing governments and their programs, the oversight provided through auditing is more critical than ever. Government auditing provides objective analysis and information needed to make the decisions necessary to help create a better future. The professional standards presented in this 2011 revision of Government Auditing Standards provide a framework for performing high-quality audit work with competence, integrity, objectivity, and independence to provide accountability and to help improve government operations and services. These standards provide the foundation for government auditors to lead by example in the areas of independence, transparency, accountability, and quality through the audit process.

The 2011 revision of Government Auditing Standards represents a modernized version of the standards, taking into account recent changes in other auditing standards, including international standards. This revision supersedes the 2007 revision. It contains the following major changes from the 2007 revision that reinforce the principles of transparency and accountability and provide the framework for high-quality government audits that add value.

- A conceptual framework for independence was added to provide a means for auditors to assess their independence for activities that are not expressly prohibited in the standards. This more principles-based approach to analyzing independence provides the framework for auditors to assess the unique facts and circumstances that arise during their work.

- This revision drops discussion surrounding certain AICPA Statements on Auditing Standards (SAS) and

Statements on Standards for Attestation Engagements (SSAE) requirements that were incorporated by reference and included in the 2007 revision, as the standards have converged in those areas.

- The definition of validity as an aspect of the quality of evidence has been clarified for performance audits.

Effective with the implementation dates for the 2011 revision of Government Auditing Standards, GAO is also retiring Government Auditing Standards: Answers to Independence Standard Questions (GAO-02-870G, July 2002).

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

The 2011 revision of Government Auditing Standards will be effective for financial audits and attestation engagements for periods ending on or after December 15, 2012, and for performance audits beginning on or after December 15, 2011. Early implementation is not permitted.

An electronic version of this document and any interpretive publications can be accessed at http://www.gao.gov/yellowbook.

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

Gene L. Dodaro
Comptroller General
of the United States

December 2011

General Standards

Introduction

3.01 This chapter establishes general standards and provides guidance for performing financial audits, attestation engagements, and performance audits under generally accepted government auditing standards (GAGAS). These general standards, along with the overarching ethical principles presented in chapter 1, establish a foundation for the credibility of auditors' work. These general standards emphasize the importance of the independence of the audit organization and its individual auditors; the exercise of professional judgment in the performance of work and the preparation of related reports; the competence of staff; and quality control and assurance.

Independence

3.02 In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent.

3.03 Independence comprises:

a. Independence of Mind
The state of mind that permits the performance of an audit without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

b. Independence in Appearance
The absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team had been compromised.

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

3.05 Except under the limited circumstances discussed in paragraphs 3.47 and 3.48, auditors should be independent from an audited entity during:

a. any period of time that falls within the period covered by the financial statements or subject matter of the audit, and

b. the period of the professional engagement, which begins when the auditors either sign an initial engagement letter or other agreement to perform an audit or begin to perform an audit, whichever is earlier. The period lasts for the entire duration of the professional relationship (which, for recurring audits, could cover many periods) and ends with the formal or informal notification, either by the auditors or the audited entity, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period of professional engagement does not necessarily end with the issuance of a report and recommence with the beginning of the following year's audit or a subsequent audit with a similar objective.

3.06 GAGAS's practical consideration of independence consists of four interrelated sections, providing:

a. a conceptual framework for making independence determinations based on facts and circumstances that are often unique to specific environments;

b. requirements for and guidance on independence for audit organizations that are structurally located within the entities they audit;

c. requirements for and guidance on independence for auditors performing nonaudit services, including indication of specific nonaudit services that always impair independence and others that would not normally impair independence; and

d. requirements for and guidance on documentation necessary to support adequate consideration of auditor independence.

GAGAS Conceptual Framework Approach to Independence

3.07 Many different circumstances, or combinations of circumstances, are relevant in evaluating threats to independence. Therefore, GAGAS establishes a conceptual framework that auditors use to identify, evaluate, and apply safeguards to address threats to independence.[29] The conceptual framework assists auditors in maintaining both independence of mind and independence in appearance. It can be applied to many variations in circumstances that create threats to independence and allows auditors to address threats to independence that result from activities that are not specifically prohibited by GAGAS.

3.08 Auditors should apply the conceptual framework at the audit organization, audit, and individual auditor levels to:

a. identify threats to independence;

[29]See Appendix II for a flowchart to assist in the application of the conceptual framework for independence.

b. evaluate the significance of the threats identified, both individually and in the aggregate; and

c. apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level.

3.09 If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

3.10 The use of the term “audit organization” in GAGAS is described in paragraph 1.07. For consideration of auditor independence, offices or units of an audit organization, or related or affiliated entities under common control, are not differentiated from one another. Consequently, for the purposes of independence evaluation using the conceptual framework, an audit organization that includes multiple offices or units, or includes multiple entities related or affiliated through common control, is considered to be one audit organization. Common ownership may also affect independence in appearance regardless of the level of control.

3.11 The GAGAS section on nonaudit services in paragraphs 3.33 through 3.58 provides requirements and guidance on evaluating threats to independence related to nonaudit services provided by auditors to audited entities. That section also enumerates specific nonaudit services that always impair auditor independence with respect to audited entities and that auditors are prohibited from providing to audited entities.

3.12 The following sections discuss threats to independence, safeguards or controls to eliminate or reduce threats, and application of the conceptual framework for independence.

Threats

3.13 Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether the threat is of such significance that it would compromise an auditor's professional judgment or create the appearance that the auditor's professional judgment may be compromised, and on the specific safeguards applied to eliminate the threat or reduce it to an acceptable level. Threats are conditions to be evaluated using the conceptual framework. Threats do not necessarily impair independence.

3.14 Threats to independence may be created by a wide range of relationships and circumstances. Auditors should evaluate the following broad categories of threats to independence when threats are being identified and evaluated:[30]

a. Self-interest threat - the threat that a financial or other interest will inappropriately influence an auditor's judgment or behavior;

b. Self-review threat - the threat that an auditor or audit organization that has provided nonaudit services will not appropriately evaluate the results of previous judgments made or services performed as part of the nonaudit services when forming a judgment significant to an audit;

c. Bias threat - the threat that an auditor will, as a result of political, ideological, social, or other convictions, take a position that is not objective;

d. Familiarity threat - the threat that aspects of a relationship with management or personnel of an

[30]See A3.02 through A3.09 for further discussion and examples of threats.

audited entity, such as a close or long relationship, or that of an immediate or close family member, will lead an auditor to take a position that is not objective;

e. Undue influence threat - the threat that external influences or pressures will impact an auditor's ability to make independent and objective judgments;

f. Management participation threat - the threat that results from an auditor's taking on the role of management or otherwise performing management functions on behalf of the entity undergoing an audit; and

g. Structural threat - the threat that an audit organization's placement within a government entity, in combination with the structure of the government entity being audited, will impact the audit organization's ability to perform work and report results objectively.

3.15 Circumstances that result in a threat to independence in one of the above categories may result in other threats as well. For example, a circumstance resulting in a structural threat to independence may also expose auditors to undue influence and management participation threats.

Safeguards

3.16 Safeguards are controls designed to eliminate or reduce to an acceptable level threats to independence. Under the conceptual framework, the auditor applies safeguards that address the specific facts and circumstances under which threats to independence exist. In some cases, multiple safeguards may be necessary to address a threat. The list of safeguards in this section provides examples that may be effective under certain circumstances. The list cannot provide safeguards for all circumstances. It may, however, provide a starting point for auditors who have identified threats to independence and are considering what safeguards could eliminate those threats or reduce them to an acceptable level.

3.17 Examples of safeguards include:

a. consulting an independent third party, such as a professional organization, a professional regulatory body, or another auditor;

b. involving another audit organization to perform or reperform part of the audit;

c. having a professional staff member who was not a member of the audit team review the work performed; and

d. removing an individual from an audit team when that individual's financial or other interests or relationships pose a threat to independence.

3.18 Depending on the nature of the audit, an auditor may also be able to place limited reliance on safeguards that the entity has implemented. It is not possible to rely solely on such safeguards to eliminate threats or reduce them to an acceptable level.

3.19 Examples of safeguards within the entity's systems and procedures include:

a. an entity requirement that persons other than management ratify or approve the appointment of an audit organization to perform an audit;

b. internal procedures at the entity that ensure objective choices in commissioning nonaudit services; and

c. a governance structure at the entity that provides appropriate oversight and communications regarding the audit organization's services.

Application of the Conceptual Framework

3.20 Auditors should evaluate threats to independence using the conceptual framework when the facts and circumstances under which the auditors perform their work may create or augment threats to independence. Auditors should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on an auditor's independence.

3.21 Facts and circumstances that create threats to independence can result from events such as the start of a new audit; assignment of new staff to an ongoing audit; and acceptance of a nonaudit service at an audited entity. Many other events can result in threats to independence. Auditors use professional judgment to determine whether the facts and circumstances created by an event warrant use of the conceptual framework. Whenever relevant new information about a threat to independence comes to the attention of the auditor during the audit, the auditor should evaluate the significance of the threat in accordance with the conceptual framework.

3.22 Auditors should determine whether identified threats to independence are at an acceptable level or have been eliminated or reduced to an acceptable level. A threat to independence is not acceptable if it either (a) could impact the auditor's ability to perform an audit without being affected by influences that compromise professional judgment or (b) could expose the auditor or audit organization to circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, or professional skepticism of the audit organization, or a member of the audit team, had been compromised.

3.23 When an auditor identifies threats to independence and, based on an evaluation of those threats, determines that they are not at an acceptable level, the auditor should determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level. The auditor should exercise professional judgment in making that determination, and should take into account whether both independence of mind and independence in appearance are maintained. The auditor should evaluate both qualitative and quantitative factors when determining the significance of a threat.

3.24 In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the auditors should document the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level.

3.25 Certain conditions may lead to threats that are so significant that they cannot be eliminated or reduced to an acceptable level through the application of safeguards, resulting in impaired independence. Under such conditions, auditors should decline to perform a prospective audit or terminate an audit in progress.[31]

3.26 If a threat to independence is initially identified after the auditors' report is issued, the auditor should evaluate the threat's impact on the audit and on GAGAS compliance. If the auditors determine that the newly identified threat had an impact on the audit that would have resulted in the auditors' report being different from the report issued had the auditors been aware of it, they should communicate in the same manner as that used to originally distribute the report to those charged with governance, the appropriate officials of the audited entity, the appropriate officials of the

[31]See paragraph 3.44 for a discussion of conditions under which an auditor may be required by law or regulation to perform both an audit and a nonaudit service and cannot decline to perform or terminate the service. See the discussion of nonaudit services beginning in paragraph 3.45 for consideration of threats related to nonaudit services that cannot be eliminated or reduced to an appropriate level.

organizations requiring or arranging for the audits, and other known users, so that they do not continue to rely on findings or conclusions that were impacted by the threat to independence. If the report was previously posted to the auditors' publicly accessible website, the auditors should remove the report and post a public notification that the report was removed. The auditors should then determine whether to conduct additional audit work necessary to reissue the report, including any revised findings or conclusions or repost the original report if the additional audit work does not result in a change in findings or conclusions.

Government Auditors and Audit Organization Structure

3.27 The ability of audit organizations in government entities to perform work and report the results objectively can be affected by placement within government and the structure of the government entity being audited. The independence standard applies to auditors in government entities whether they report to third parties externally (external auditors), to senior management within the audited entity (internal auditors), or to both.

External Auditor Independence

3.28 Audit organizations that are structurally located within government entities are often subject to constitutional or statutory safeguards that mitigate the effects of structural threats to independence. For external audit organizations, such safeguards may include governmental structures under which a government audit organization is:

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

b. placed within a different branch of government from that of the audited entity; for example, legislative auditors auditing an executive branch program.

3.29 Safeguards other than those described above may mitigate threats resulting from governmental structures. For external auditors or auditors who report both externally and internally, structural threats may be mitigated if the head of an audit organization meets any of the following criteria in accordance with constitutional or statutory requirements:

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

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

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

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

3.30 In addition to the criteria in paragraphs 3.28 and 3.29, GAGAS recognizes that there may be other organizational structures under which external audit organizations in government entities could be considered to be independent. If appropriately designed and implemented, these structures provide safeguards that prevent the audited entity from interfering with the audit organization's ability to perform the work and report the results impartially. For an external audit organization or one that reports both externally and internally to be considered independent under a structure different from the ones listed in paragraphs 3.28 and 3.29, the audit organization should have all of the following safeguards. In such situations, the audit organization should document how each of the following safeguards was satisfied and provide the documentation to those performing quality control monitoring and to the external peer reviewers to determine whether all the necessary safeguards are in place. The following safeguards may also be used to augment those listed in paragraphs 3.28 and 3.29:

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

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

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

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

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

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

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

Internal Auditor Independence

3.31 Certain entities employ auditors to work for entity management. These auditors may be subject to administrative direction from persons involved in the entity management process. Such audit organizations are internal audit functions and are encouraged to use the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing* in conjunction with GAGAS. In accordance with GAGAS, internal auditors who work under the direction of the audited entity's management are considered independent for the purposes of reporting internally if the head of the audit organization meets all of the following criteria:

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

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

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

d. has access to those charged with governance; and

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

3.32 When internal audit organizations perform audits of external parties such as auditing contractors or outside party agreements, and no impairments to independence exist, the audit organization can be considered independent as an external audit organization of those external parties.

Provision of Nonaudit Services to Audited Entities

3.33 Auditors have traditionally provided a range of nonaudit services that are consistent with their skills and expertise to entities at which they perform audits. Providing such nonaudit services may create threats to an auditor's independence.

Requirements for Performing Nonaudit Services

3.34 Before an auditor agrees to provide a nonaudit service to an audited entity, the auditor should determine whether providing such a service would create a threat to independence, either by itself or in aggregate with other nonaudit services provided, with respect to any GAGAS audit it performs. A critical component of this determination is consideration of management's ability to effectively oversee the nonaudit service to be performed. The auditor should determine that the audited entity has designated an individual who possesses suitable skill, knowledge, or experience, and that the individual understands the services to be performed sufficiently to oversee them. The individual is not required to possess the expertise to perform or reperform the services. The auditor should document consideration of management's ability to effectively oversee nonaudit services to be performed.

3.35 If an auditor were to assume management responsibilities for an audited entity, the management participation threats created would be so significant that no safeguards could reduce them to an acceptable level. Management responsibilities involve leading and directing an entity, including making decisions regarding the acquisition, deployment and control of human, financial, physical, and intangible resources.

3.36 Whether an activity is a management responsibility depends on the facts and circumstances and auditors exercise professional judgment in identifying these activities. Examples of activities that are considered management responsibilities and would therefore impair independence if performed for an audited entity include:

a. setting policies and strategic direction for the audited entity;

b. directing and accepting responsibility for the actions of the audited entity's employees in the performance of their routine, recurring activities;

c. having custody of an audited entity's assets;

d. reporting to those charged with governance on behalf of management;

e. deciding which of the auditor's or outside third party's recommendations to implement;

f. accepting responsibility for the management of an audited entity's project;

g. accepting responsibility for designing, implementing, or maintaining internal control;

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

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

j. serving as a voting member of an audited entity's management committee or board of directors.

3.37 Auditors performing nonaudit services for entities for which they perform audits should obtain assurance that audited entity management performs the following functions in connection with the nonaudit services:

a. assumes all management responsibilities;

b. oversees the services, by designating an individual, preferably within senior management, who possess suitable skill, knowledge, or experience;[32]

c. evaluates the adequacy and results of the services performed; and

d. accepts responsibility for the results of the services.

3.38 In cases where the audited entity is unable or unwilling to assume these responsibilities (for example, the audited entity does not have an individual with suitable skill, knowledge, or experience to oversee the nonaudit services provided, or is unwilling to perform such functions due to lack of time or desire), the auditor's provision of these services would impair independence.

3.39 In connection with nonaudit services, auditors should establish and document their understanding with the audited entity's management or those charged with governance, as appropriate, regarding the following:

a. objectives of the nonaudit service;

b. services to be performed;

c. audited entity's acceptance of its responsibilities;

[32]See paragraph 3.34 for additional discussion of management's ability to effectively oversee the nonaudit service.

d. the auditor’s responsibilities; and

e. any limitations of the nonaudit service.

3.40 Routine activities performed by auditors that relate directly to the performance of an audit, such as providing advice and responding to questions as part of an audit, are not considered nonaudit services under GAGAS. Such routine activities generally involve providing advice or assistance to the entity on an informal basis as part of an audit. Routine activities typically are insignificant in terms of time incurred or resources expended and generally do not result in a specific project or engagement or in the auditors producing a formal report or other formal work product. However, activities such as financial statement preparation, cash to accrual conversions, and reconciliations are considered nonaudit services under GAGAS, not routine activities related to the performance of an audit, and are evaluated using the conceptual framework as discussed in paragraph 3.46.

3.41 Routine activities directly related to an audit include the following:

a. providing advice to the audited entity on an accounting matter as an ancillary part of the overall financial audit;

b. researching and responding to the audited entity’s technical questions on relevant tax laws as an ancillary part of providing tax services;

c. providing advice to the audited entity on routine business matters;

d. educating the audited entity on matters within the technical expertise of the auditors; and

e. providing information to the audited entity that is readily available to the auditors, such as best practices and benchmarking studies.

3.42 An auditor who previously performed nonaudit services for an entity that is a prospective subject of an audit should evaluate the impact of those nonaudit services on independence before accepting an audit. If the nonaudit services were performed in the period to be covered by the audit, the auditor should (1) determine if the nonaudit service is expressly prohibited by GAGAS and, if not, (2) determine whether a threat to independence exists and address any threats noted in accordance with the conceptual framework.

3.43 Nonaudit services provided by auditors can impact independence of mind and in appearance in periods subsequent to the period in which the nonaudit service was provided. For example, if auditors have designed and implemented an accounting and financial reporting system that is expected to be in place for many years, a threat to independence in appearance for future financial audits or attestation engagements performed by those auditors may exist in subsequent periods. For recurring audits, having another independent audit organization perform an audit of the areas affected by the nonaudit service may provide a safeguard that allows the audit organization that provided the nonaudit service to mitigate the threat to its independence. Auditors use professional judgment to determine whether the safeguards adequately mitigate the threats.

3.44 An auditor in a government entity may be required to perform a nonaudit service that could impair the auditor's independence with respect to a required audit. If the auditor cannot, as a consequence of constitutional or statutory requirements over which the auditor has no control, implement safeguards to reduce the resulting threat to an acceptable level, or decline to perform or terminate a nonaudit service that is incompatible with audit responsibilities, the auditor should disclose the nature of the threat that could not be eliminated or reduced to an acceptable level and modify the GAGAS compliance statement accordingly.[33]

Consideration of Specific Nonaudit Services

3.45 By their nature, certain nonaudit services directly support the entity's operations and impair auditors' ability to maintain independence in mind and appearance. The nonaudit services discussed below are among those frequently requested of auditors working in a government environment. Some aspects of these services will impair an auditor's ability to perform audits for the entities for which the services are provided. The specific services indicated are not the only nonaudit services that would impair an auditor's independence.

3.46 Auditors may be able to provide nonaudit services in the broad areas indicated in paragraphs 3.49 through 3.58 without impairing independence if (1) the nonaudit services are not expressly prohibited, (2) the auditor has determined that the requirements for performing nonaudit services in paragraphs 3.34 through 3.44 have been met, and (3) any significant threats to independence have been eliminated or reduced to an acceptable level through the application of safeguards. Auditors should use the conceptual framework to evaluate independence given the facts and circumstances of individual services not specifically prohibited in this section.

3.47 For performance audits and agreed-upon procedures engagements, nonaudit services that are

[33]See paragraphs 2.24 and 2.25 for the discussion of modifications to the GAGAS compliance statement.

otherwise prohibited by GAGAS may be provided when such services do not relate to the specific subject matter of the engagement.

3.48 For financial statement audits and examination or review engagements, a nonaudit service performed during the period covered by the financial statements may not impair an auditor's independence with respect to those financial statements provided that the following conditions exist:

a. the nonaudit service was provided prior to the period of professional engagement;

b. the nonaudit service related only to periods prior to the period covered by the financial statements; and

c. the financial statements for the period to which the nonaudit service did relate were audited by another auditor (or in the case of an examination or review engagement, examined, reviewed, or audited by another auditor as appropriate).

Management Responsibilities

3.49 If performed on behalf of an audited entity by the entity's auditor, management responsibilities such as those listed in paragraph 3.36 would create management participation threats so significant that no safeguards could reduce them to an acceptable level. Consequently the auditor's independence would be impaired with respect to that entity.

Preparing Accounting Records and Financial Statements

3.50 Some services involving preparation of accounting records always impair an auditor's independence with respect to an audited entity. These services include:

a. determining or changing journal entries, account codes or classifications for transactions, or other accounting records for the entity without obtaining management's approval;

b. authorizing or approving the entity’s transactions; and

c. preparing or making changes to source documents without management approval. Source documents include those providing evidence that transactions have occurred (for example, purchase orders, payroll time records, customer orders, and contracts). Such records also include an audited entity’s general ledger and subsidiary records or equivalent.

3.51 Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, even if the auditor assisted in drafting those financial statements. Consequently, an auditor’s acceptance of responsibility for the preparation and fair presentation of financial statements that the auditor will subsequently audit would impair the auditor’s independence.

3.52 Services related to preparing accounting records and financial statements that an auditor may be able to provide to an audited entity if the conditions in paragraph 3.46 are met include:

a. recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an audited entity’s general ledger;

b. preparing financial statements based on information in the trial balance;

c. posting entries that have been approved by an audited entity’s management to the entity’s trial balance;

d. preparing account reconciliations that identify reconciling items for the audited entity management's evaluation; and

e. proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to an audited entity's management provided management reviews and accepts the entries and the auditor is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

Internal Audit Assistance Services Provided by External Auditors

3.53 Internal audit assistance services involve assisting an entity in the performance of its internal audit activities. Certain internal audit assistance activities always impair an external auditor's independence with respect to an audited entity. These activities include:

a. setting internal audit policies or the strategic direction of internal audit activities;

b. performing procedures that form part of the internal control, such as reviewing and approving changes to employee data access privileges; and

c. determining the scope of the internal audit function and resulting work.

Internal Control Monitoring as a Nonaudit Service

3.54 Accepting responsibility for designing, implementing or maintaining internal control includes accepting responsibility for designing, implementing, or maintaining monitoring procedures.[34] Monitoring involves the use of either ongoing monitoring procedures or separate evaluations to gather and analyze persuasive information supporting conclusions about the effectiveness of the internal control system.

[34]See A.03 and A.04 for a discussion of internal control.

Ongoing monitoring procedures performed on behalf of management are built into the routine, recurring operating activities of an organization. Therefore, the management participation threat created if an auditor performs or supervises ongoing monitoring procedures is so significant that no safeguards could reduce the threat to an acceptable level.

3.55 Separate evaluations are sometimes performed as nonaudit services by individuals who are not directly involved in the operation of the controls being monitored. As such, it is possible for an auditor to provide an objective analysis of control effectiveness by performing separate evaluations without creating a management participation threat that would impair independence. However, in all such cases, the significance of the threat created by performing separate evaluations should be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Auditors should assess the frequency of the separate evaluations as well as the scope or extent of the controls (in relation to the scope of the audit performed) being tested when evaluating the significance of the threat. An evaluation prepared as a nonaudit service is not a substitute for audit procedures in a GAGAS audit.

Information Technology Systems Services

3.56 Services related to information technology (IT) systems include the design or implementation of hardware or software systems. The systems may aggregate source data, form part of the internal control over the subject matter of the audit, or generate information that affects the subject matter of the audit. IT services that would impair independence if provided by an audit organization to an audited entity include:

a. designing or developing a financial or other IT system that will play a significant role in the management of an area of operations that is or will be the subject matter of an audit;

b. providing services that entail making other than insignificant modifications to the source code underlying such a system; and

c. operating or supervising the operation of such a system.

Valuation Services

3.57 A valuation comprises the making of assumptions with regard to future developments, the application of appropriate methodologies and techniques, and the combination of both to compute a certain value, or range of values, for an asset, a liability, or an entity as a whole. If an audit organization provides valuation services to an audited entity and the valuations would have a material effect, separately or in the aggregate, on the financial statements or other information on which it is reporting, and the valuation involves a significant degree of subjectivity, the audit organization's independence would be impaired.

Other Nonaudit Services

3.58 Provision of certain other nonaudit services always impairs an external auditor's independence with respect to an audited entity. These activities include:

a. Non tax disbursement – prohibited nonaudit services

(1) Accepting responsibility to authorize payment of audited entity funds, electronically or otherwise.

(2) Accepting responsibility for signing or cosigning audited entity checks, even if only in emergency situations.

(3) Maintaining an audited entity's bank account or otherwise having custody of an audited entity's funds or making credit or banking decisions for the audited entity.

(4) Approving vendor invoices for payment.

b. Benefit plan administration – prohibited nonaudit services

(1) Making policy decisions on behalf of audited entity management.

(2) When dealing with plan participants, interpreting the plan document on behalf of management without first obtaining management's concurrence.

(3) Making disbursements on behalf of the plan.

(4) Having custody of a plan's assets.

(5) Serving a plan as a fiduciary as defined by the Employee Retirement Income Security Act (ERISA).

c. Investment—advisory or management—prohibited nonaudit services

(1) Making investment decisions on behalf of audited entity management or otherwise having discretionary authority over an audited entity's investments.

(2) Executing a transaction to buy or sell an audited entity's investment.

(3) Having custody of an audited entity's assets, such as taking temporary possession of securities purchased by an audited entity.

d. Corporate finance—consulting or advisory – prohibited nonaudit services

(1) Committing the audited entity to the terms of a transaction or consummating a transaction on behalf of the audited entity.

(2) Acting as a promoter, underwriter, broker-dealer, or guarantor of audited entity securities, or distributor of private placement memoranda or offering documents.

(3) Maintaining custody of an audited entity's securities.

e. Executive or employee personnel matters – prohibited nonaudit services

(1) Committing the audited entity to employee compensation or benefit arrangements.

(2) Hiring or terminating audited entity employees.

f. Business risk consulting – prohibited nonaudit services

(1) Making or approving business risk decisions.

(2) Presenting business risk considerations to those charged with governance or others on behalf of management.

Documentation

3.59 Documentation of independence considerations provides evidence of the auditor's judgments in forming conclusions regarding compliance with independence requirements. GAGAS contains specific requirements for documentation related to independence which may be in addition to the documentation that auditors have previously maintained. While insufficient documentation of an auditor's compliance with the independence standard does not impair independence, appropriate documentation is required under the GAGAS quality control and assurance requirements.[35] The independence standard includes the following documentation requirements:

a. document threats to independence that require the application of safeguards, along with safeguards applied, in accordance with the conceptual framework for independence as required by paragraph 3.24;

b. document the safeguards required by paragraph 3.30 if an audit organization is structurally located within a government entity and is considered independent based on those safeguards;

c. document consideration of audited entity management's ability to effectively oversee a nonaudit service to be provided by the auditor as indicated in paragraph 3.34; and

d. document the auditor's understanding with an audited entity for which the auditor will perform a nonaudit service as indicated in paragraph 3.39.

Professional Judgment

3.60 Auditors must use professional judgment in planning and performing audits and in reporting the results.

3.61 Professional judgment includes exercising reasonable care and professional skepticism. Reasonable care includes acting diligently in accordance with applicable professional standards and ethical principles. Professional skepticism is an attitude that includes a questioning mind and a critical

[35]See paragraph 3.84 for additional discussion of documenting compliance with quality control policies and procedures and paragraph 3.88 for additional discussion of policies and procedures on independence, legal, and ethical requirements.

assessment of evidence. Professional skepticism includes a mindset in which auditors assume neither that management is dishonest nor of unquestioned honesty.

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

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

3.64 Using professional judgment is important to auditors in carrying out all aspects of their professional responsibilities, including following the independence standards and related conceptual framework; maintaining objectivity and credibility; assigning competent staff to the audit; defining the scope of work; evaluating, documenting, and reporting the results of the work; and maintaining appropriate quality control over the audit process.

3.65 Using professional judgment is important to auditors in applying the conceptual framework to determine independence in a given situation. This includes the consideration of any threats to the auditor's independence and related safeguards which may mitigate the identified threats. Auditors use professional judgment in identifying and evaluating any threats to independence, including threats to the appearance of independence.[36]

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

3.67 An auditor's consideration of the risk level of each audit, including the risk of arriving at improper conclusions, is also important. Within the context of audit risk, exercising professional judgment in determining the sufficiency and appropriateness of evidence to be used to support the findings and conclusions based on the audit objectives and any recommendations reported is an integral part of the audit process.

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

[36]See paragraph 3.03 for a description of independence in appearance.

Competence

3.69 The staff assigned to perform the audit must collectively possess adequate professional competence needed to address the audit objectives and perform the work in accordance with GAGAS.

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

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

Technical Knowledge

3.72 The staff assigned to conduct an audit in accordance with GAGAS should collectively possess the technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning work on that audit. The staff assigned to a GAGAS audit should collectively possess

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

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

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

d. skills appropriate for the work being performed; for example, skills in

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

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

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

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

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

Additional Qualifications for Financial Audits and Attestation Engagements

3.73 Auditors performing financial audits should be knowledgeable in U.S. generally accepted accounting principles (GAAP), or with the applicable financial reporting framework being used, and the American Institute of Certified Public Accountants' (AICPA)

Statements on Auditing Standards (SAS)[37]and they should be competent in applying these SASs to the audit work.

3.74 Similarly, auditors performing attestation engagements should be knowledgeable in the AICPA general attestation standard related to criteria, the AICPA attestation standards for field work and reporting, and the related Statements on Standards for Attestation Engagements (SSAE),[38] and they should be competent in applying these standards and SSAE to the attestation work.[39]

3.75 Auditors engaged to perform financial audits or attestation engagements should be licensed certified public accountants, persons working for a licensed certified public accounting firm or for a government auditing organization, or licensed accountants in states that have multi-class licensing systems that recognize licensed accountants other than certified public accountants.

Continuing Professional Education

3.76 Auditors performing work in accordance with GAGAS, including planning, directing, performing audit procedures, or reporting on an audit conducted in accordance with GAGAS, should maintain their professional competence through continuing professional education (CPE). Therefore, each auditor performing work in accordance with GAGAS should complete, every 2 years, at least 24 hours of CPE that

[37]See paragraph 2.08 and 4.01 for discussion of the AICPA standards incorporated into GAGAS for financial audits.

[38]See paragraphs 2.09 and 5.01 for discussion of the AICPA standards incorporated into GAGAS for attestation engagements.

[39]See paragraphs 2.19 through 2.22 for additional information on the relationship between GAGAS and other professional standards for financial audits and attestation engagements.

directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates. Auditors who are involved in any amount of planning, directing, or reporting on GAGAS audits and auditors who are not involved in those activities but charge 20 percent or more of their time annually to GAGAS audits should also obtain at least an additional 56 hours of CPE (for a total of 80 hours of CPE in every 2-year period) that enhances the auditor's professional proficiency to perform audits. Auditors required to take the total 80 hours of CPE should complete at least 20 hours of CPE in each year of the 2-year periods. Auditors hired or initially assigned to GAGAS audits after the beginning of an audit organization's 2-year CPE period should complete a prorated number of CPE hours.

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

3.78 Meeting CPE requirements is primarily the responsibility of individual auditors. The audit organization should have quality control procedures to help ensure that auditors meet the continuing education requirements, including documentation of the CPE completed. The Government Accountability Office (GAO) has developed guidance pertaining to CPE requirements to assist auditors and audit organizations in exercising professional judgment in complying with the CPE requirements.[40]

CPE Requirements for Specialists

3.79 The audit team should determine that external specialists assisting in performing a GAGAS audit are qualified and competent in their areas of specialization; however, external specialists are not required to meet the GAGAS CPE requirements.

3.80 The audit team should determine that internal specialists consulting on a GAGAS audit who are not involved in directing, performing audit procedures, or reporting on a GAGAS audit, are qualified and competent in their areas of specialization; however, these internal specialists are not required to meet the GAGAS CPE requirements.

3.81 The audit team should determine that internal specialists, who are performing work in accordance with GAGAS as part of the audit team, including directing, performing audit procedures, or reporting on a GAGAS audit, comply with GAGAS, including the CPE requirements.[41] The GAGAS CPE requirements become effective for internal specialists when an audit organization first assigns an internal specialist to an audit. Because internal specialists apply specialized knowledge in government audits, training in their areas of specialization qualify under the requirement for 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates.

[40] *Government Auditing Standards: Guidance on GAGAS Requirements for Continuing Professional Education*, GAO-05-568G (Washington, D.C.: April 2005), http://www.gao.gov/yellowbook.

[41] See paragraphs 3.76 through 3.81 for discussion of the CPE requirements.

Quality Control and Assurance

3.82 Each audit organization performing audits in accordance with GAGAS must:

a. establish and maintain a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements,[42] and

b. have an external peer review performed by reviewers independent of the audit organization being reviewed at least once every 3 years.

System of Quality Control

3.83 An audit organization's system of quality control encompasses the audit organization's leadership, emphasis on performing high quality work, and the organization's policies and procedures designed to provide reasonable assurance of complying with professional standards and applicable legal and regulatory requirements. The nature, extent, and formality of an audit organization's quality control system will vary based on the audit organization's circumstances, such as the audit organization's size, number of offices and geographic dispersion, knowledge and experience of its personnel, nature and complexity of its audit work, and cost-benefit considerations.

3.84 Each audit organization should document its quality control policies and procedures and communicate those policies and procedures to its personnel. The audit organization should document compliance with its quality control policies and procedures and maintain such documentation for a

[42]See paragraph A3.10 for additional discussion of the system of quality control.

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

3.85 An audit organization should establish policies and procedures in its system of quality control that collectively address

a. leadership responsibilities for quality within the audit organization,

b. independence, legal, and ethical requirements,

c. initiation, acceptance, and continuance of audits,

d. human resources,

e. audit performance, documentation, and reporting, and

f. monitoring of quality.

Leadership Responsibilities for Quality within the Audit Organization

3.86 Audit organizations should establish policies and procedures on leadership responsibilities for quality within the audit organization that include the designation of responsibility for quality of audits performed in accordance with GAGAS and communication of policies and procedures relating to quality. Appropriate policies and communications encourage a culture that recognizes that quality is essential in performing GAGAS audits and that leadership of the audit organization is ultimately responsible for the system of quality control.

3.87 The audit organization should establish policies and procedures designed to provide it with reasonable assurance that those assigned operational responsibility for the audit organization's system of quality control have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.

Independence, Legal, and Ethical Requirements

3.88 Audit organizations should establish policies and procedures on independence, legal, and ethical requirements that are designed to provide reasonable assurance that the audit organization and its personnel maintain independence and comply with applicable legal and ethical requirements.[43] Such policies and procedures assist the audit organization to

a. communicate its independence requirements to its staff, and

b. identify and evaluate circumstances and relationships that create threats to independence, and take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, withdraw from the audit where withdrawal is not prohibited by law or regulation.

Initiation, Acceptance, and Continuance of Audits

3.89 Audit organizations should establish policies and procedures for the initiation, acceptance, and continuance of audits that are designed to provide reasonable assurance that the audit organization will undertake audits only if it can comply with professional standards, legal requirements, and ethical principles

[43]See paragraphs 3.02 through 3.59 for GAGAS independence requirements. See chapter 1 for GAGAS ethical principles.

and is acting within the legal mandate or authority of the audit organization.[44]

Human Resources

3.90 Audit organizations should establish policies and procedures for human resources that are designed to provide the audit organization with reasonable assurance that it has personnel with the capabilities and competence to perform its audits in accordance with professional standards and legal and regulatory requirements.[45]

Audit Performance, Documentation, and Reporting

3.91 Audit organizations should establish policies and procedures for audit performance, documentation, and reporting that are designed to provide the audit organization with reasonable assurance that audits are performed and reports are issued in accordance with professional standards and legal and regulatory requirements.[46]

3.92 When performing GAGAS audits, audit organizations should have policies and procedures for the safe custody and retention of audit documentation for a time sufficient to satisfy legal, regulatory, and administrative requirements for records retention. Whether audit documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying information could be compromised if the documentation is altered, added to, or deleted without the auditors' knowledge, or if the documentation is lost or damaged. For audit documentation that is retained electronically, the audit organization should

[44]See paragraph A3.10a for discussion of initiation of audits by government audit organizations.

[45]See paragraphs 3.69 through 3.81 for requirements related to professional competence.

[46]For financial audits, chapters 2 through 4 apply; for attestation engagements, chapters 2, 3 and 5 apply; for performance audits, chapters 2, 3, 6, and 7 apply.

establish effective information systems controls concerning accessing and updating the audit documentation.

Monitoring of Quality

3.93 Audit organizations should establish policies and procedures for monitoring of quality in the audit organization.[47] Monitoring of quality is an ongoing, periodic assessment of work completed on audits designed to provide management of the audit organization with reasonable assurance that the policies and procedures related to the system of quality control are suitably designed and operating effectively in practice. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of whether the:

a. professional standards and legal and regulatory requirements have been followed,

b. quality control system has been appropriately designed, and

c. quality control policies and procedures are operating effectively and complied with in practice.

3.94 Monitoring procedures will vary based on the audit organization's facts and circumstances. The audit organization should perform monitoring procedures that enable it to assess compliance with applicable professional standards and quality control policies and procedures for GAGAS audits. Individuals performing monitoring should collectively have sufficient expertise and authority for this role.

3.95 The audit organization should analyze and summarize the results of its monitoring process at least

[47]See paragraph A3.10c for additional discussion of monitoring.

annually, with identification of any systemic or repetitive issues needing improvement, along with recommendations for corrective action. The audit organization should communicate to appropriate personnel any deficiencies noted during the monitoring process and make recommendations for appropriate remedial action.

External Peer Review

3.96 The audit organization should obtain an external peer review at least once every 3 years that is sufficient in scope to provide a reasonable basis for determining whether, for the period under review, the reviewed audit organization's system of quality control was suitably designed and whether the audit organization is complying with its quality control system in order to provide the audit organization with reasonable assurance of conforming with applicable professional standards.

3.97 The first peer review for an audit organization not already subject to a peer review requirement covers a review period ending no later than 3 years from the date an audit organization begins its first audit in accordance with GAGAS. The period under review generally covers 1 year, although peer review programs may choose a longer review period. Generally, the deadlines for peer review reports are established by the entity that administers the peer review program. Extensions of the deadlines for submitting the peer review report exceeding 3 months beyond the due date are granted by the entity that administers the peer review program and GAO.

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

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

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

c. review of selected auditors' reports and related documentation;

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

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

3.99 The peer review team should perform an assessment of peer review risk to help determine the number and types of audits to select for review.[48] Based on the risk assessment, the team should use one or a combination of the following approaches to select individual audits for review with greater emphasis on those audits with higher assessed levels of peer review risk: (1) select GAGAS audits that provide a reasonable cross-section of the GAGAS audits performed by the reviewed audit organization; or (2) select audits that provide a reasonable cross-section from all types of work subject to the reviewed audit organization's quality control system, including one or more audits performed in accordance with GAGAS. The second approach is generally applicable to audit organizations that perform only a small number of GAGAS audits in relation to other types of audits. In these cases, one or more GAGAS audits may represent more than what would be

[48]See paragraph A3.11 for examples of factors to consider in assessing peer review risk.

selected when looking at a cross-section of the audit organization's work as a whole.

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

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

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

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

d. reference to a separate written communication, if issued under the peer review program.

3.101 The peer review team uses professional judgment in deciding the type of peer review report. The following are the types of peer review reports.

a. Peer Review Rating of Pass: A conclusion that the audit organization's system of quality control has been suitably designed and complied with to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.

b. Peer Review Rating of Pass with Deficiencies: A conclusion that the audit organization's system of quality control has been suitably designed and complied with to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects with the exception of a certain deficiency or deficiencies that are described in the report.

c. Peer Review Rating of Fail: A conclusion, based on the significant deficiencies that are described in the report, that the audit organization's system of quality control is not suitably designed to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects, or the audit organization has not complied with its system of quality control to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.

3.102 When the scope of the review is limited by conditions that preclude the application of one or more peer review procedures considered necessary in the circumstances and the peer reviewer cannot accomplish the objectives of those procedures through alternative procedures, the types of reports described in paragraphs 3.101 a-c are modified by including statements in the report's scope paragraph, body and opinion paragraph. These statements describe the relationship of the excluded audit(s) or functional area(s) to the reviewed organization's full scope of practice and system of quality control and the effects of the exclusion on the scope and results of the review.

3.103 For any deficiencies or significant deficiencies included in the peer review report or other written communication, the peer review team should include, either in the peer review report or in a separate written communication, a detailed description of the findings, conclusions, and recommendations related to the deficiencies or significant deficiencies.

3.104 The peer review team should meet the following criteria:

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

b. The organization conducting the peer review and individual review team members are independent (as defined in GAGAS)[49] of the audit organization being reviewed, its staff, and the audits selected for the peer review.

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

3.105 An external audit organization[50] should make its most recent peer review report publicly available.[51] For example, an audit organization may satisfy this requirement by posting the peer review report on a publicly available web site or to a publicly available file designed for public transparency of peer review results. Alternatively, if neither of these options is available to the audit organization, then it should use the same transparency mechanism it uses to make other information public. The audit organization should provide the peer review report to others upon request. If a separate communication detailing findings, conclusions, and recommendations is issued, public

[49]See paragraphs 3.02 through 3.32 for discussion of independence.

[50]See paragraph 1.07b for the definition of “audit organizations” and paragraph 1.08 for discussion of external audit organizations.

[51]See paragraph A3.12 for additional discussion of peer review report transparency.

availability of that communication is not required. Internal audit organizations that report internally to management and those charged with governance should provide a copy of the peer review report to those charged with governance.

3.106 Information in peer review reports may be relevant to decisions on procuring audits. Therefore, audit organizations seeking to enter into a contract to perform an audit in accordance with GAGAS should provide the following to the party contracting for such services when requested:

a. the audit organization's most recent peer review report, and

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

3.107 Auditors who are using another audit organization's work should request a copy of the audit organization's latest peer review report and any other written communication issued, and the audit organization should provide these documents when requested.[52]

[52]See paragraphs 6.40 through 6.44 for additional discussion on using the work of other auditors.

environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring. The objectives of internal control relate to (1) financial reporting, (2) operations, and (3) compliance. Safeguarding of assets is a subset of these objectives. Management designs internal control to provide reasonable assurance that unauthorized acquisition, use, or disposition of assets will be prevented or timely detected and corrected.

A.04 In addition to the COSO framework, the publication, *Standards for Internal Control in the Federal Government*,[174] which incorporates the concepts developed by COSO, provides definitions and fundamental concepts pertaining to internal control at the federal level and may also be useful to auditors at other levels of government. The related *Internal Control Management and Evaluation Tool*,[175] based on the federal internal control standards, provides a systematic, organized, and structured approach to assessing the internal control structure.

Examples of Deficiencies in Internal Control

A.05 GAGAS contains requirements for reporting identified deficiencies in internal control.

a. For financial audits, see paragraphs 4.19 through 4.24.

b. For attestation engagements, see paragraphs 5.20 through 5.23.

[174]*Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

[175]*Internal Control Management and Evaluation Tool*, GAO-01-1008G (Washington, D.C.: August 2001).

c. For performance audits, see paragraphs 7.19 through 7.20.

A.06 The following are examples of control deficiencies:

a. Insufficient control consciousness within the organization. For example, the tone at the top and the control environment. Control deficiencies in other components of internal control could lead the auditor to conclude that weaknesses exist in the control environment.

b. Ineffective oversight by those charged with governance of the entity's financial reporting, performance reporting, or internal control, or an ineffective overall governance structure.

c. Control systems that did not prevent, or detect and correct material misstatements so that it was necessary to restate previously issued financial statements or operational results. Control systems that did not prevent or detect material misstatements in performance or operational results so that it was later necessary to make significant corrections to those results.

d. Control systems that did not prevent, or detect and correct material misstatements identified by the auditor. This includes misstatements involving estimation and judgment for which the auditor identifies potential material adjustments and corrections of the recorded amounts.

e. An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for a large or complex entity.

f. Identification of fraud of any magnitude on the part of senior management.

g. Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either to correct it or to conclude that it does not need to be corrected.

h. Inadequate controls for the safeguarding of assets.

i. Evidence of intentional override of internal control by those in authority to the detriment of the overall objectives of the system.

j. Deficiencies in the design or operation of internal control that could fail to prevent, or detect and correct, fraud, noncompliance with provisions of laws, regulations, contracts or grant agreements, or abuse having a material effect on the financial statements or the audit objective.

k. Inadequate design of information systems general, application, and user controls that prevent the information system from providing complete and accurate information consistent with financial, compliance, or performance reporting objectives or other current needs.

l. Failure of an application control caused by a deficiency in the design or operation of an information systems general control.

m. Employees or management who lack the qualifications and training to fulfill their assigned functions.

Examples of Abuse

A.07 GAGAS contains requirements for responding to indications of material abuse and reporting abuse that is material to the audit objectives.

a. For financial audits, see paragraphs 4.07 and 4.08 and 4.25 through 4.27.

b. For attestation engagements, see paragraphs 5.08 through 5.09 and 5.24 through 5.26.

c. For performance audits, see paragraphs 6.33 and 6.34 and 7.21 through 7.23.

A.08 The following are examples of abuse, depending on the facts and circumstances:

a. Creating unneeded overtime.

b. Requesting staff to perform personal errands or work tasks for a supervisor or manager.

c. Misusing the official's position for personal gain (including actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an official's personal financial interests or those of an immediate or close family member; a general partner; an organization for which the official serves as an officer, director, trustee, or employee; or an organization with which the official is negotiating concerning future employment).

d. Making travel choices that are contrary to existing travel policies or are unnecessarily extravagant or expensive.

e. Making procurement or vendor selections that are contrary to existing policies or are unnecessarily extravagant or expensive.

Examples of Indicators of Fraud Risk

A.09 GAGAS contains requirements relating to evaluating fraud risk.

a. For financial audits, see paragraphs 4.06 and 4.25 through 4.27.

b. For attestation engagements, see paragraphs 5.07, 5.20, and 5.24 through 5.26.

c. For performance audits, see paragraphs 6.30 through 6.32 and 7.21 through 7.23.

A.10 In some circumstances, conditions such as the following might indicate a heightened risk of fraud:

a. economic, programmatic, or entity operating conditions threaten the entity’s financial stability, viability, or budget;

b. the nature of the entity’s operations provide opportunities to engage in fraud;

c. management’s monitoring of compliance with policies, laws, and regulations is inadequate;

d. the organizational structure is unstable or unnecessarily complex;

e. communication and/or support for ethical standards by management is lacking;

f. management is willing to accept unusually high levels of risk in making significant decisions;

g. the entity has a history of impropriety, such as previous issues with fraud, waste, abuse, or questionable practices, or past audits or investigations with findings of questionable or criminal activity;

h. operating policies and procedures have not been developed or are outdated;

i. key documentation is lacking or does not exist;

j. asset accountability or safeguarding procedures is lacking;

k. improper payments;

l. false or misleading information;

m. a pattern of large procurements in any budget line with remaining funds at year end, in order to “use up all of the funds available;” and

n. unusual patterns and trends in contracting, procurement, acquisition, and other activities of the entity or program.

Determining Whether Provisions of Laws, Regulations, Contracts and Grant Agreements Are Significant within the Context of the Audit Objectives

A.11 GAGAS contains requirements for determining whether provisions of laws, regulations, contracts or grant agreements are significant within the context of the audit objectives.

a. For financial audits, see paragraphs 4.19 through 4.22.

b. For attestation engagements, see paragraphs 5.07 and 5.08.

c. For performance audits, see paragraphs 6.28 and 6.29.

A.12 Government programs are subject to many provisions of laws, regulations, contracts or grant agreements. At the same time, their significance within the context of the audit objectives varies widely, depending on the objectives of the audit. Auditors may find the following approach helpful in assessing whether provisions of laws, regulations, contracts or grant agreements are significant within the context of the audit objectives:

a. Express each audit objective in terms of questions about specific aspects of the program being audited (that is, purpose and goals, internal control, inputs, program operations, outputs, and outcomes).

b. Identify provisions of laws, regulations, contracts or grant agreements that directly relate to specific aspects of the program within the context of the audit objectives.

c. Determine if the audit objectives or the auditors' conclusions could be significantly affected if noncompliance with those provisions of laws, regulations, contracts or grant agreements occurred. If the audit objectives or audit conclusions could be significantly affected, then those provisions of laws, regulations, contracts or grant agreements are likely to be significant to the audit objectives.

A.13 Auditors may consult with their own legal counsel to (1) determine those laws and regulations that are significant to the audit objectives, (2) design tests of compliance with laws and regulations, or (3) evaluate the results of those tests. Auditors also may consult with their own legal counsel when audit objectives require testing compliance with provisions of contracts or grant agreements. Depending on the circumstances of the audit, auditors may consult with others, such as investigative staff, other audit organizations or government entities that provided professional services to the audited entity, or applicable law enforcement authorities, to obtain information on compliance matters.

Information to Accompany Chapter 1

A1.01 Chapter 1 discusses the use and application of GAGAS and the role of auditing in government accountability. Those charged with governance and management of audited organizations also have roles in government accountability. The discussion that follows is provided to assist auditors in understanding the roles of others in accountability. The following section also contains background information on the laws, regulations, or other authoritative sources that require the use of GAGAS. This information is provided to place GAGAS within the context of overall government accountability.

Laws, Regulations, and Other Authoritative Sources That Require Use of GAGAS

A1.02 Laws, regulations, contracts, grant agreements, or policies frequently require the use of GAGAS.[176] The following are some of the laws, regulations, and or other authoritative sources that require the use of GAGAS:

a. The Inspector General Act of 1978, as amended, 5 U.S.C. App. requires that the statutorily appointed federal inspectors general comply with GAGAS for audits of federal establishments, organizations, programs, activities, and functions. The act further states that the inspectors general shall take appropriate steps to assure that any work performed by nonfederal auditors complies with GAGAS.

b. The Chief Financial Officers Act of 1990 (Public Law 101-576), as expanded by the Government Management Reform Act of 1994 (Public Law 103-356), requires that GAGAS be followed in audits of executive branch departments' and agencies' financial statements. The Accountability of Tax Dollars Act of 2002 (Public Law 107-289) generally extends this

[176] See paragraph 1.06 for additional discussion on the use of GAGAS.

requirement to most executive agencies not subject to the Chief Financial Officers Act unless they are exempted for a given year by the Office of Management and Budget (OMB).

c. The Single Audit Act Amendments of 1996 (Public Law 104-156) require that GAGAS be followed in audits of state and local governments and nonprofit entities that receive federal awards. OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, which provides the governmentwide guidelines and policies on performing audits to comply with the Single Audit Act, also requires the use of GAGAS.

A1.03 Other laws, regulations, or authoritative sources may require the use of GAGAS. For example, auditors at the state and local levels of government may be required by state and local laws and regulations to follow GAGAS. Also, auditors may be required by the terms of an agreement or contract to follow GAGAS. Auditors may also be required to follow GAGAS by federal audit guidelines pertaining to program requirements, such as those issued for Housing and Urban Development programs and Student Financial Aid programs. Being alert to such other laws, regulations, or authoritative sources may assist auditors in performing their work in accordance with the required standards.

A1.04 Even if not required to do so, auditors may find it useful to follow GAGAS in performing audits of federal, state, and local government programs as well as audits of government awards administered by contractors, nonprofit entities, and other nongovernmental entities. Many audit organizations not formally required to do so, both in the United States of America and in other countries, voluntarily follow GAGAS.

The Role of Those Charged with Governance

A1.05 During the course of GAGAS audits, auditors communicate with those charged with governance.[177]

a. For financial audits, see paragraphs 4.03 and 4.04.

b. For attestation engagements, see paragraphs 5.04 and 5.05.

c. For performance audits, see paragraphs 6.47 through 6.50.

A1.06 Those charged with governance are responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process, subject matter, or program under audit including related internal controls. In certain entities covered by GAGAS, those charged with governance may also be part of the entity's management. In some audit entities, multiple parties may be charged with governance, including oversight bodies, members or staff of legislative committees, boards of directors, audit committees, or parties contracting for the audit.

A1.07 Because the governance structures of government entities and organizations can vary widely, it may not always be clearly evident who is charged with key governance functions. In these situations, auditors evaluate the organizational structure for directing and controlling operations to achieve the audited entity's objectives. This evaluation also includes how the audited entity delegates authority and establishes accountability for its management personnel.

[177] See paragraph 1.02 for additional discussion of those charged with governance.

Management's Role

A1.08 Managers have fundamental responsibilities for carrying out government functions.[178] Management of the audited entity is responsible for

a. using its financial, physical, and informational resources legally, effectively, efficiently, economically, ethically, and equitably to achieve the purposes for which the resources were furnished or the program was established;

b. complying with applicable laws and regulations (including identifying the requirements with which the entity and the official are responsible for compliance);

c. implementing systems designed to achieve compliance with applicable laws and regulations;

d. establishing and maintaining effective internal control to help ensure that appropriate goals and objectives are met; following laws and regulations; and ensuring that management and financial information is reliable and properly reported;

e. providing appropriate reports to those who oversee their actions and to the public in order to demonstrate accountability for the resources and authority used to carry out government programs and the results of these programs;

f. addressing the findings and recommendations of auditors, and for establishing and maintaining a process to track the status of such findings and recommendations;

[178]See paragraphs 1.01 and 1.02 for additional discussion of management and officials of government programs.

g. following sound procurement practices when contracting for audits, including ensuring procedures are in place for monitoring contract performance; and

h. taking timely and appropriate steps to remedy fraud, noncompliance with provisions of laws, regulations, contracts or grant agreements, or abuse that auditors report.

Information to Accompany Chapter 2

Attestation Engagements

A2.01 Examples of attestation engagements objectives[179] include

a. prospective financial or performance information;

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

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

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

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

f. the accuracy and reliability of reported performance measures;

[179]See paragraph 2.09 for additional discussion of attestation engagements.

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

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

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

Performance Audit Objectives

A2.02 Examples of program effectiveness and results audit objectives[180] include:

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

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

c. analyzing the relative cost-effectiveness of a program or activity, focusing on combining cost information or other inputs with information about outputs or the benefit provided or with outcomes or the results achieved;

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

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

[180]See paragraph 2.11a for additional discussion of program effectiveness and results audit objectives.

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

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

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

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

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

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

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

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

n. determining whether fees assessed cover costs;

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

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

A2.03 Examples of audit objectives related to internal control[181] include an assessment of the extent to which internal control provides reasonable assurance about whether

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

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

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

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

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

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

A2.04 Compliance objectives[182] include determining whether

[181]See paragraph 2.11b for additional discussion of internal control audit objectives.

[182]See paragraph 2.11c for additional discussion of compliance audit objectives.

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

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

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

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

A2.05 Examples of objectives pertaining to prospective analysis[183] include providing conclusions based on

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

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

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

d. prospective information prepared by management;

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

[183]See paragraph 2.11d for additional discussion of prospective analysis audit objectives.

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

GAGAS Compliance Statements

A2.06 The determination of whether an unmodified or modified GAGAS compliance statement is appropriate is based on the consideration of the individual and aggregate effect of exceptions to GAGAS requirements.[184] Quantitative and qualitative factors that the auditor may consider include:

a. the likelihood that the exception(s) will affect the perceptions of report users about the audit findings, conclusions, and recommendations;

b. the magnitude of the effect of the exception(s) on the perceptions of report users about the audit findings, conclusions, and recommendations;

c. the pervasiveness of the exception(s);

d. the potential effect of the exception(s) on the sufficiency and appropriateness of evidence supporting the audit findings, conclusions, and recommendations; and

e. whether report users could be misled if the GAGAS compliance statement were not modified.

Information to Accompany Chapter 3

A3.01 Chapter 3 discusses the general standards applicable to financial audits, attestation engagements, and performance audits in accordance with GAGAS. The following supplemental guidance is provided to assist auditors and audited entities in avoiding

[184]See paragraphs 2.24 and 2.25 for additional discussion on citing compliance with GAGAS.

impairments to independence, establishing a system of quality control, and identifying peer review risk factors.

Threats to Independence

A3.02 This list is intended to illustrate by example the types of circumstances that create threats to independence that an auditor might identify when applying the conceptual framework.[185] It does not include all circumstances that create threats to independence; these circumstances will be unique to the conditions under which each evaluation takes place.

A3.03 Examples of circumstances that create self-interest threats for an auditor include:

a. A member of the audit team having a direct financial interest in the audited entity. This would not preclude auditors from auditing pension plans that they participate in if (1) the auditor has no control over the investment strategy, benefits, or other management issues associated with the pension plan and (2) the auditor belongs to such pension plan as part of his/her employment with the audit organization, provided that the plan is normally offered to all employees in equivalent employment positions.

b. An audit organization having undue dependence on income from a particular audited entity.

c. A member of the audit team entering into employment negotiations with an audited entity.

d. An auditor discovering a significant error when evaluating the results of a previous professional service performed by a member of the auditor's audit organization.

[185]See paragraphs 3.07 through 3.26.

A3.04 Examples of circumstances that create self-review threats for an auditor include:

a. An audit organization issuing a report on the effectiveness of the operation of financial or performance management systems after designing or implementing the systems.

b. An audit organization having prepared the original data used to generate records that are the subject matter of the audit.

c. An audit organization performing a service for an audited entity that directly affects the subject matter information of the audit.

d. A member of the audit team being, or having recently been, employed by the audited entity in a position to exert significant influence over the subject matter of the audit.

A3.05 Examples of circumstances that create bias threats for an auditor include:

a. An auditor's having preconceptions about the objectives of a program under audit that are sufficiently strong to impact the auditor's objectivity.

b. An auditor's having biases associated with political, ideological, or social convictions that result from membership or employment in, or loyalty to, a particular type of policy, group, organization, or level of government that could impact the auditor's objectivity.

A3.06 Examples of circumstances that create familiarity threats for an auditor include:

a. A member of the audit team having a close or immediate family member who is a principal or senior manager of the audited entity.

b. A member of the audit team having a close or immediate family member who is an employee of the audited entity and is in a position to exert significant influence over the subject matter of the audit.

c. A principal or employee of the audited entity in a position to exert significant influence over the subject matter of the audit having recently served on the audit team.

d. An auditor accepting gifts or preferential treatment from an audited entity, unless the value is trivial or inconsequential.

e. Senior audit personnel having a long association with the audited entity.

A3.07 Examples of circumstances that create undue influence threats for an auditor or audit organization include existence of:

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

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

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

d. External interference over the assignment, appointment, compensation, and promotion of audit personnel.

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

f. Authority to overrule or to inappropriately influence the auditors' judgment as to the appropriate content of the report.

g. Threat of replacing the auditors over a disagreement with the contents of an auditors' report, the auditors' conclusions, or the application of an accounting principle or other criteria.

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

A3.08 Examples of circumstances that create management participation threats for an auditor include:

a. A member of the audit team being, or having recently been, a principal or senior manager of the audited entity.

b. An audit organization principal or employee serving as a voting member of an entity's management committee or board of directors, making policy decisions that affect future direction and operation of an entity's programs, supervising entity employees, developing or approving programmatic policy, authorizing an entity's transactions, or maintaining custody of an entity's assets.

c. An audit organization principal or employee recommending a single individual for a specific position that is key to the entity or program under audit, or otherwise ranking or influencing management's selection of the candidate.

d. An auditor preparing management's corrective action plan to deal with deficiencies detected in the audit.

A3.09 Examples of circumstances that create structural threats for an auditor include:

a. For both external and internal audit organizations, structural placement of the audit function within the reporting line of the areas under audit.

b. For internal audit organizations, administrative direction from the audited entity's management.

System of Quality Control

A3.10 Chapter 3 discusses the elements of an audit organization's system of quality control.[186] The following supplemental guidance is provided to assist auditors and audit organizations in establishing policies and procedures in its system of quality control to address the following elements: initiation, acceptance, and continuance of audits; audit performance, documentation, and reporting; and monitoring.

a. Government audit organizations initiate audits as a result of (1) legal mandates, (2) requests from legislative bodies or oversight bodies, and (3) the audit organization's discretion. In the case of legal mandates and requests, a government audit organization may be required to perform the audit and may not be permitted

[186] See paragraphs 3.82 through 3.95 for additional discussion of the system of quality control.

to make decisions about acceptance or continuance and may not be permitted to resign or withdraw from the audit.

b. GAGAS standards for audit performance, documentation, and reporting are in chapter 4 for financial audits, chapter 5 for attestation engagements, and chapters 6 and 7 for performance audits. Chapter 3 specifies that an audit organization's quality control system include policies and procedures designed to provide the audit organization with reasonable assurance that audits are performed and reports are issued in accordance with professional standards and legal and regulatory requirements.[187] Examples of such policies and procedures include the following:

(1) communication provided to team members so that they sufficiently understand the objectives of their work and the applicable professional standards;

(2) audit planning and supervision;

(3) appropriate documentation of the work performed;

(4) review of the work performed, the significant judgments made, and the resulting audit documentation and report;

(5) review of the independence and qualifications of any external specialists or contractors used, as well as a review of the scope and quality of their work;

(6) procedures for resolving difficult or contentious issues or disagreements among team members, including specialists;

[187]See paragraphs 3.82 through 3.95 for additional discussion of quality control policies and procedures.

(7) obtaining and addressing comments from the audited entity on draft reports; and

(8) reporting supported by the evidence obtained, and in accordance with applicable professional standards and legal or regulatory requirements.

c. Monitoring is an ongoing, periodic assessment of audits designed to provide management of the audit organization with reasonable assurance that the policies and procedures related to the system of quality control are suitably designed and operating effectively in practice.[188] The following guidance is provided to assist audit organizations with implementing and continuing its monitoring of quality:

(1) Who: Monitoring is most effective when performed by persons who do not have responsibility for the specific activity being monitored (e.g., for specific audits or specific centralized processes). The staff member or team of staff members assigned with responsibility for the monitoring process collectively need sufficient and appropriate competence and authority in the audit organization to assume that responsibility. Generally the staff member or the team of staff members performing the monitoring are apart from the normal audit supervision associated with individual audits.

(2) How much: The extent of monitoring procedures varies based on the audit organization's circumstances to enable the audit organization to assess compliance with applicable professional standards and the audit organization's quality control policies and procedures. Examples of specific monitoring procedures include

[188]See paragraphs 3.93 through 3.95 for additional discussion of monitoring.

(a) examination of selected administrative and personnel records pertaining to quality control;

(b) review of selected audit documentation and reports;

(c) discussions with the audit organization's personnel (as applicable and appropriate);

(d) periodic summarization of the findings from the monitoring procedures in writing (at least annually), and consideration of the systematic causes of findings that indicate improvements are needed;

(e) determination of any corrective actions to be taken or improvements to be made with respect to the specific audits reviewed or the audit organization's quality control policies and procedures;

(f) communication of the identified findings to appropriate audit organization management with subsequent follow-up; and

(g) consideration of findings by appropriate audit organization management personnel who also determine whether actions necessary, including necessary modifications to the quality control system, are performed on a timely basis.

(3) Review of selected administrative and personnel records: The review of selected administrative and personnel records pertaining to quality control may include tests of

(a) compliance with policies and procedures on independence;

(b) compliance with continuing professional development policies, including training;

(c) procedures related to recruitment and hiring of qualified personnel, including hiring of specialists or consultants when needed;

(d) procedures related to performance evaluation and advancement of personnel;

(e) procedures related to initiation, acceptance, and continuance of audits;

(f) audit organization personnel's understanding of the quality control policies and procedures, and implementation of these policies and procedures; and

(g) audit organization's process for updating its policies and procedures.

(4) Follow-up on previous findings: Monitoring procedures include an evaluation of whether the audit organization has taken appropriate corrective action to address findings and recommendations from previous monitoring and peer reviews. Personnel involved in monitoring use this information as part of the assessment of risk associated with the design and implementation of the audit organization's quality control system and in determining the nature, timing, and extent of monitoring procedures.

(5) Communication: The audit organization communicates internally the results of the monitoring of its quality control systems that allows the audit organization to take prompt and appropriate action where necessary. Information included in this communication includes:

(a) a description of the monitoring procedures performed;

(b) the conclusions drawn from the monitoring procedures; and

(c) where relevant, a description of the systemic, repetitive, or other significant deficiencies and of the actions taken to resolve those deficiencies.

Peer Review

A3.11 Examples of the factors to consider when performing an assessment of peer review risk for selecting audits for peer review[189] include:

a. scope of the audits including size of the audited entity or audits covering multiple locations;

b. functional area or type of government program;

c. types of audits provided, including the extent of nonaudit services provided to audited entities;

d. personnel (including use of new personnel or personnel not routinely assigned the types of audits provided);

e. initial audits;

f. familiarity resulting from a longstanding relationship with the audited entity;

g. political sensitivity of the audits;

h. budget constraints for the audit organization;

i. results of the peer review team's review of the design of system of quality control;

[189]See paragraph 3.99 for additional discussion of the assessment of peer review risk.

j. results of the audit organization's monitoring process; and

k. risk sensitivity of the audit organization.

A3.12 As discussed in paragraph 3.105, an external audit organization should make its most recent peer review report publicly available. Examples of how to achieve this transparency requirement include posting the peer review report on an external Web site or to a publicly available file. To help the public understand the peer review reports, an audit organization may also include a description of the peer review process and how it applies to its organization. The following provides examples of additional information that audit organizations may include to help users understand the meaning of the peer review report.

a. Explanation of the peer review process.

b. Description of the audit organization's system of quality control.

c. Explanation of the relationship of the peer review results to the audited organization's work.

d. If the peer review report that includes deficiencies or significant deficiencies is modified, explanation of the reviewed audit organization's plan for improving quality controls and the status of the improvements.

Information to Accompany Chapter 6

A6.01 Chapter 6 discusses the field work standards for performance audits. An integral concept for performance auditing is the use of sufficient, appropriate evidence based on the audit objectives to support a sound basis for audit findings, conclusions, and recommendations. The following discussion is provided to assist auditors in identifying criteria and the various types of evidence, including assessing the appropriateness of evidence in relation to the audit objectives.

Types of Criteria

A6.02 The following are some examples of criteria:[190]

a. purpose or goals prescribed by law or regulation or set by officials of the audited entity,

b. policies and procedures established by officials of the audited entity,

c. technically developed standards or norms,

d. expert opinions,

e. prior periods' performance,

f. defined business practices,

g. contract or grant terms, and

h. performance of other entities or sectors used as defined benchmarks.

A6.03 Audit objectives may pertain to describing the current status or condition of a program or process. For this type of audit objective, criteria may also be represented by the assurance added by the auditor's (1) description of the status or condition, (2) evaluation of whether the status or condition meets certain characteristics, or (3) evaluation of whether management's description is verifiable, accurate, or supported.

[190]See paragraph 6.37 for additional discussion on identifying audit criteria.

Types of Evidence

A6.04 In terms of its form and how it is collected, evidence may be categorized as physical, documentary, or testimonial. Physical evidence is obtained by auditors' direct inspection or observation of people, property, or events. Such evidence may be documented in summary memos, photographs, videos, drawings, charts, maps, or physical samples. Documentary evidence is obtained in the form of already existing information such as letters, contracts, accounting records, invoices, spreadsheets, database extracts, electronically stored information, and management information on performance. Testimonial evidence is obtained through inquiries, interviews, focus groups, public forums, or questionnaires. Auditors frequently use analytical processes including computations, comparisons, separation of information into components, and rational arguments to analyze any evidence gathered to determine whether it is sufficient and appropriate.[191] The strength and weakness of each form of evidence depends on the facts and circumstances associated with the evidence and professional judgment in the context of the audit objectives.

Appropriateness of Evidence in Relation to the Audit Objectives

A6.05 One of the primary factors influencing the assurance associated with a performance audit is the appropriateness of the evidence in relation to the audit objectives.[192] For example:

a. The audit objectives might focus on verifying specific quantitative results presented by the audited entity. In these situations, the audit procedures would likely focus

[191]See paragraphs 6.67 and 6.60 for definitions of sufficient and appropriate.

[192]See paragraphs 6.60 through 6.66 for additional discussion on the appropriateness of evidence.

on obtaining evidence about the accuracy of the specific amounts in question. This work may include the use of statistical sampling.

b. The audit objectives might focus on the performance of a specific program or activity in the agency being audited. In these situations, the auditor may be provided with information compiled by the agency being audited in order to answer the audit objectives. The auditor may find it necessary to test the quality of the information, which includes both its validity and reliability.

c. The audit objectives might focus on information that is used for widely accepted purposes and obtained from sources generally recognized as appropriate. For example, economic statistics issued by government agencies for purposes such as adjusting for inflation, or other such information issued by authoritative organizations, may be the best information available. In such cases, it may not be practical or necessary for auditors to conduct procedures to verify the information. These decisions call for professional judgment based on the nature of the information, its common usage or acceptance, and how it is being used in the audit.

d. The audit objectives might focus on comparisons or benchmarking between various government functions or agencies. These types of audits are especially useful for analyzing the outcomes of various public policy decisions. In these cases, auditors may perform analyses, such as comparative statistics of different jurisdictions or changes in performance over time, where it would be impractical to verify the detailed data underlying the statistics. Clear disclosure as to what extent the comparative information or statistics were evaluated or corroborated will likely be necessary to place the evidence in context for report users.

e. The audit objectives might focus on trend information based on data provided by the audited entity. In this situation, auditors may assess the evidence by using overall analytical tests of underlying data, combined with a knowledge and understanding of the systems or processes used for compiling information.

f. The audit objectives might focus on the auditor identifying emerging and cross-cutting issues using information compiled or self-reported by agencies. In such cases, it may be helpful for the auditor to consider the overall appropriateness of the compiled information along with other information available about the program. Other sources of information, such as inspector general reports or other external audits, may provide the auditors with information regarding whether any unverified or self-reported information is consistent with or can be corroborated by these other external sources of information.

Findings

A6.06 When the audit objectives include explaining why a particular type of positive or negative program performance, output, or outcome identified in the audit occurred, they are referred to as "cause."[193] Identifying the cause of problems may assist auditors in making constructive recommendations for correction. Because deficiencies can result from a number of plausible factors or multiple causes, the recommendation can be more persuasive if auditors can clearly demonstrate and explain with evidence and reasoning the link between the deficiencies and the factor or factors they have identified as the cause or causes. Auditors may also identify deficiencies in program design or structure as the cause of deficient performance. Auditors may also identify deficiencies in internal control that are

[193]See paragraph 6.76 for additional discussion of "cause."

significant to the subject matter of the performance audit as the cause of deficient performance. In developing these types of findings, the deficiencies in program design or internal control would be described as the "cause." Often the causes of deficient program performance are complex and involve multiple factors, including fundamental, systemic root causes. Alternatively, when the audit objectives include estimating the program's effect on changes in physical, social, or economic conditions, auditors seek evidence of the extent to which the program itself is the "cause" of those changes.

A6.07 When the audit objectives include estimating the extent to which a program has caused changes in physical, social, or economic conditions, "effect" is a measure of the impact achieved by the program. In this case, "effect" is the extent to which positive or negative changes in actual physical, social, or economic conditions can be identified and attributed to the program.

Information to Accompany Chapter 7

A7.01 Chapter 7 discusses the reporting standards for performance audits. The following discussion is provided to assist auditors in developing and writing their audit report for performance audits.

Report Quality Elements

A7.02 The auditor may use the report quality elements of timely, complete, accurate, objective, convincing, clear, and concise when developing and writing the audit report as the subject permits.[194]

a. Accurate: An accurate report is supported by sufficient, appropriate evidence with key facts, figures,

[194]See paragraph 7.08 for additional discussion of report contents.

and findings being traceable to the audit evidence. Reports that are fact-based, with a clear statement of sources, methods, and assumptions so that report users can judge how much weight to give the evidence reported, assist in achieving accuracy. Disclosing data limitations and other disclosures also contribute to producing more accurate audit reports. Reports also are more accurate when the findings are presented in the broader context of the issue. One way to help audit organizations prepare accurate audit reports is to use a quality control process such as referencing. Referencing is a process in which an experienced auditor who is independent of the audit checks that statements of facts, figures, and dates are correctly reported, that the findings are adequately supported by the evidence in the audit documentation, and that the conclusions and recommendations flow logically from the evidence.

b. Objective: Objective means that the presentation of the report is balanced in content and tone. A report's credibility is significantly enhanced when it presents evidence in an unbiased manner and in the proper context. This means presenting the audit results impartially and fairly. The tone of reports may encourage decision makers to act on the auditors' findings and recommendations. This balanced tone can be achieved when reports present sufficient, appropriate evidence to support conclusions while refraining from using adjectives or adverbs that characterize evidence in a way that implies criticism or unsupported conclusions. The objectivity of audit reports is enhanced when the report explicitly states the source of the evidence and the assumptions used in the analysis. The report may recognize the positive aspects of the program reviewed if applicable to the audit objectives. Inclusion of positive program aspects may lead to improved performance by other government organizations that read the report. Audit reports are more objective when they demonstrate that the work has been performed by professional, unbiased, independent, and knowledgeable staff.

c. Complete: Being complete means that the report contains sufficient, appropriate evidence needed to satisfy the audit objectives and promote an understanding of the matters reported. It also means the report states evidence and findings without omission of significant relevant information related to the audit objectives. Providing report users with an understanding means providing perspective on the extent and significance of reported findings, such as the frequency of occurrence relative to the number of cases or transactions tested and the relationship of the findings to the entity's operations. Being complete also means clearly stating what was and was not done and explicitly describing data limitations, constraints imposed by restrictions on access to records, or other issues.

d. Convincing: Being convincing means that the audit results are responsive to the audit objectives, that the findings are presented persuasively, and that the conclusions and recommendations flow logically from the facts presented. The validity of the findings, the reasonableness of the conclusions, and the benefit of implementing the recommendations are more convincing when supported by sufficient, appropriate evidence. Reports designed in this way can help focus the attention of responsible officials on the matters that warrant attention and can provide an incentive for taking corrective action.

e. Clear: Clarity means the report is easy for the intended user to read and understand. Preparing the report in language as clear and simple as the subject permits assists auditors in achieving this goal. Use of straightforward, nontechnical language is helpful to simplify presentation. Defining technical terms, abbreviations, and acronyms that are used in the report is also helpful. Auditors may use a highlights page or summary within the report to capture the report user's attention and highlight the overall message. If a summary is used, it is helpful if it focuses on the specific answers to the questions in the audit objectives, summarizes the audit's most significant findings and the report's principal conclusions, and prepares users to anticipate the major recommendations. Logical organization of material, and accuracy and precision in stating facts and in drawing conclusions assist in the report's clarity and understanding. Effective use of titles and captions and topic sentences makes the report easier to read and understand. Visual aids (such as pictures, charts, graphs, and maps) may clarify and summarize complex material.

f. Concise: Being concise means that the report is not longer than necessary to convey and support the message. Extraneous detail detracts from a report, may even conceal the real message, and may confuse or distract the users. Although room exists for considerable judgment in determining the content of reports, those that are fact-based but concise are likely to achieve results.

g. Timely: To be of maximum use, providing relevant evidence in time to respond to officials of the audited entity, legislative officials, and other users' legitimate needs is the auditors' goal. Likewise, the evidence provided in the report is more helpful if it is current. Therefore, the timely issuance of the report is an important reporting goal for auditors. During the audit, the auditors may provide interim reports of significant matters to appropriate entity officials. Such communication alerts officials to matters needing immediate attention and allows them to take corrective action before the final report is completed.

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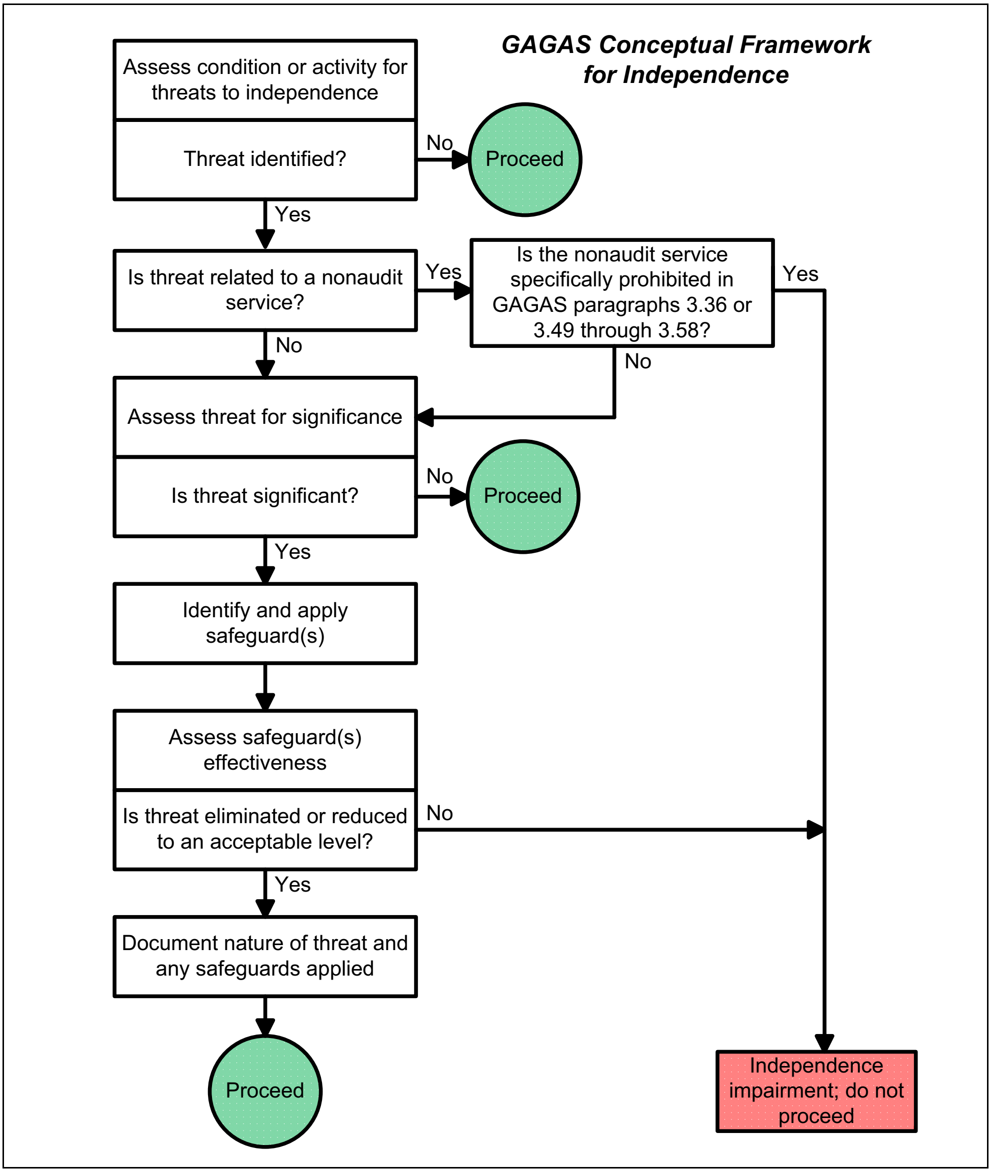

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GAO Project Team

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James R. Dalkin, Project Director
Robert F. Dacey, Chief Accountant
Marcia B. Buchanan, Assistant Director
Cheryl E. Clark, Assistant Director
Heather I. Keister, Assistant Director
Kristen A. Kociolek, Assistant Director
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