Chapter 26

Internal and Governmental Financial Auditing and Operational Auditing

■ Concept Checks

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1. Internal auditors who perform financial auditing are responsible for evaluating whether their company's internal controls are designed and operating effectively and whether the financial statements are fairly presented. This responsibility is essentially the same as the responsibility of external auditors who perform financial audits. The two types of auditors are also similar in that they both must be competent and must remain objective in performing their work and reporting their results. Despite these similarities, the role of the internal auditor in financial auditing differs from that of an external auditor in the following ways:
   - Because internal auditors spend all of their time with one company, their knowledge about the company's operations and internal controls is much greater than the external auditor's knowledge.
   - Guidelines for performing internal audits are not as well defined as the guidelines for external auditors.
   - Internal auditors are responsible to the management of the companies that they work for, while external auditors are responsible to financial statement users.
   - Because internal auditors are responsible to management, their decisions about materiality and risks may differ from the decisions of external auditors.

2. Governmental financial audits are similar to audits of commercial companies in that both types of audits require the auditor to be independent, to accumulate and evaluate evidence, and to apply AICPA auditing standards (GAAS). The two types of audits are different because governmental financial audits also require the auditor to apply generally accepted governmental auditing standards (GAGAS), which are broader than AICPA auditing standards and include testing for compliance with laws and regulations. Governmental financial auditing can be done either by auditors employed by federal and state governments (governmental auditors) or by CPA firms.

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1. The three major differences between financial and operational auditing are:

   - *Purpose of the audit.* Financial auditing emphasizes whether historical information was correctly recorded. Operational auditing emphasizes effectiveness and efficiency. The financial audit is oriented to the past, whereas an operational audit concerns operating performance for the future.
   - *Distribution of the reports.* For financial auditing, the report is typically distributed to many users of financial statements, such as stockholders and bankers. Operational audit reports are intended primarily for management.
   - *Inclusion of nonfinancial areas.* Operational audits cover any aspect of efficiency and effectiveness in an organization and can therefore involve a wide variety of activities. Financial audits are limited to matters that directly affect the fairness of financial statement presentations.

2. Criteria for evaluating efficiency and effectiveness in operational auditing means deciding the specific objectives that should have been achieved in the operation being audited. Usually, it is insufficient to state that the criteria are efficient and effective operations. More specific criteria are usually described. The following are five possible specific criteria for evaluating effectiveness of an IT system for payroll:

   - Was payroll completed and computer generated payroll checks prepared at least 12 hours before the payroll distribution deadline in each of the past 26 weeks?
   - Were there two or less complaints by employees each week in the past 26 weeks concerning incorrect paychecks that are attributable to the IT system?
   - Is there a weekly review of the completed payroll by a person who is qualified to evaluate whether the payroll is reasonable?
   - Is the weekly error listing reviewed by the payroll system's analyst to evaluate whether the payroll system should be changed?
   - Does the IT payroll system for each branch office include the specific application controls for payroll that are recommended by the home office?

■ Review Questions

26-1 The two categories of standards in the IIA International Standards for the Professional Practice of Auditing are (1) Attribute Standards and (2) Performance Standards.

26-1 (continued)

The *Attribute Standards* are:

- Purpose, authority, and responsibility
- Independence and objectivity
- Impairment to independence or objectivity
- Proficiency and due professional care
- Quality assurance and improvement program

The *Performance Standards* are:

- Managing the internal audit activity
- Nature of work
- Engagement planning
- Performing the engagement
- Communicating results
- Monitoring progress
- Communicating the acceptance of risks

26-2 External auditors are considered more independent than internal auditors for the audit of historical financial statements because their audit report is intended for the use of external users. From an internal user's perspective, internal auditors are employees of the company being audited.

Internal auditors can achieve independence by reporting to the board of directors or president. The responsibilities of internal auditors affect their independence. The internal auditor should not be responsible for performing operating functions in a company or for correcting deficiencies when ineffective or inefficient operations are found.

26-3 The Single Audit Act was created in 1984 to eliminate redundancy in the audits of governmental agencies. The Single Audit Act provides for a single coordinated audit to satisfy the audit requirements of all federal funding agencies. The Single Audit Act was originally only applicable to audits of state and local governments, but the requirements of the Act were extended in 1990 to higher-education institutions and other not-for-profit organizations through the issuance of OMB Circular A-133.

26-4 The auditing standards of the Yellow Book are consistent with the principles in AICPA auditing standards.

Some important additions and modifications are as follows:

- *Materiality and significance.* The Yellow Book recognizes that acceptable audit risk and performance materiality may be lower in governmental audits than in audits of commercial enterprises.
- *Quality control.* Organizations that audit government entities must have an appropriate system of internal quality control and must participate in an external quality control review program.

26-4 (continued)

- *Compliance auditing*. The Yellow Book requires that the audit be designed to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a material and direct effect on the financial statements.
- *Reporting*. The audit report must state that the audit was made in accordance with generally accepted government auditing standards (GAGAS). In addition, the report on financial statements must describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests, or refer to a separate report containing that information.
- *Audit files*. The Yellow Book indicates that audit files should contain sufficient information to enable an experienced reviewer with no previous connection to the audit to ascertain from the audit files evidence that supports the auditors' significant conclusions and judgments.

26-5 The primary specific objectives that must be incorporated into the design of audit tests under the Single Audit Act are as follows:

- Amounts reported as expenditures were for allowable services.
- Records indicate that those who received services or benefits were eligible to receive them.
- Matching requirements, levels of effort, and earmarking limitations were met.

26-6 The revised OMB Circular A-133 greatly simplified reporting under the Single Audit Act. The following reports are required:

1. An opinion on whether the financial statements are in accordance with GAAP.
2. An opinion as to whether the schedule of federal awards is presented fairly in all material respects in relation to the financial statements as a whole.
3. A report on internal control related to the financial statements and major programs.
4. A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report can be combined with the report on internal control.
5. A schedule of findings and questioned costs.

26-7 An operational audit is the review of any part of an organization's operating procedures and methods for the purpose of evaluating efficiency and effectiveness.

26-8 Effectiveness refers to the accomplishment of objectives, whereas efficiency refers to the resources used to achieve those objectives. An example of an operational audit for effectiveness would be to assess whether a governmental agency has met its assigned objective of achieving elevator safety in a city. An example of efficiency is when two different production processes manufacture a product of identical quality, the process with the least cost is considered to be most efficient.

26-9 The following are the distinctions between the three kinds of operational audits and an example of each for a not-for-profit hospital:

TYPES OF OPERATIONAL AUDIT	EXAMPLE FOR A HOSPITAL
Functional Functions are a means of categorizing the activities of a business, such as the billing function or production function. A functional operational audit deals with any of these functions.	Review of the payroll department to determine if the operations are effectively and efficiently performed.
Organizational An operational audit of an organization deals with an entire organizational unit, such as a department, branch, or subsidiary.	Review of the entire hospital for inefficiencies found in any department in the hospital.
Special assignment Special operational auditing assignments arise at the request of management for anything of concern to management.	Review of the IT system for failure to bill insurance companies for reimbursable charges.

26-10 Internal auditors are in a unique position to perform operational audits. They spend all of their time working for the organization they are auditing. They therefore develop considerable knowledge about the entity and its business, which is essential to effective operational auditing.

26-11 Different federal and state government auditors perform operational auditing, often as a part of doing financial audits. The most widely recognized government auditors group is the United States Government Accountability Office (GAO). In addition, each state has an Auditor General's office that has similar responsibilities to the GAO. There are also auditors for most state treasury departments and various other state government auditors.

26-11 (continued)

There are no significant differences between internal and governmental auditors' roles and opportunities for operational auditing. Internal auditors ordinarily do operational audits of for-profit organizations, whereas governmental auditors perform the same role for governmental units.

26-12 It is common, as a part of doing an audit of historical financial statements, for CPA firms to also identify operational problems and make recommendations that may benefit the audit client. The recommendations can be made orally, but they are typically communicated through a *management letter*.

It is also common for the client to engage a CPA firm to do operational auditing of one or more specific parts of its business. Usually, such an engagement would occur only if the company does not have an internal audit staff or if the internal audit staff lacks expertise in a certain area. In most cases, specialized management services staff of the CPA firm, rather than the auditing staff, performs these services. For example, a private company may ask the CPA firm to evaluate the efficiency and effectiveness of its computer systems. Auditors of public companies have to be especially cautious due to the prohibition of many non-audit services for public company audit clients.

26-13 The three phases of operational auditing are planning, evidence accumulation and evaluation, and reporting and follow-up. These phases have equivalents in historical financial statement audits, but each phase is, of course, somewhat different, given the focus on the audit of operations rather than the audit of historical financial statements.

26-14 Planning in an operational audit is similar to the audit of historical financial statements. Like audits of financial statements, the operational auditor must determine the scope of the engagement and communicate that to the organizational unit. It is also necessary to properly staff the engagement, obtain background information about the organizational unit, evaluate internal controls, and decide the appropriate evidence to accumulate.

The major difference between planning an operational audit and a financial audit is the extreme diversity in operational audits. Because of the diversity, it is often difficult to decide on specific objectives of an operational audit. Another difference is that staffing is often more complicated in an operational audit than in a financial audit. This is because the areas covered by operational audits are diverse and often require special technical skills.

26-15 Two major differences in operational and financial auditing affect operational auditing reports. First, in operational audits, the report is usually sent only to management, with a copy to the unit being audited. The lack of third-party users reduces the need for standardized wording in operational auditing reports. Second, the diversity of operational audits requires a tailoring of each report to address the scope of the audit, findings, and recommendations.

■ Multiple Choice Questions from CPA Examinations

26-16 a. (3) b. (3) c. (2)

26-17 a. (1) b. (2) c. (3)

26-18 a. (4) b. (4) c. (4)

■ Multiple Choice Questions from Becker CPA Exam Review

26-19 a. (1) b. (3) c. (4)

■ Discussion Questions and Problems

26-20 a. Objectivity means that the internal auditor must have, and maintain, an unbiased and independent viewpoint in the performance of audit tests, evaluation of the results, and issuance of the audit findings. Objectivity would not exist if the internal auditor were to audit his/her own work. Objectivity implies no subordination of judgment to another and a lack of influence by others over the internal auditor.

b. 1. Objectivity is not impaired. Assistance with the development of written policies and procedures to guide Lajod's staff is a responsibility of the internal audit staff. The internal auditors are responsible for the independent evaluation and verification of proper internal controls.

2. Objectivity is impaired. The preparation of bank reconciliations is an internal check over cash. In order to maintain objectivity, the auditor should not perform assignments that are included as part of the independent evaluation and verification of proper internal controls. Separation of duties should be maintained.

3. Objectivity is not impaired in the review of the budget for reasonableness if the internal auditor has no responsibility for establishing or implementing the budget. Objectivity is also not impaired if the internal auditor merely reviews budget variances and explanations for those variances. Objectivity would be impaired, however, if the internal auditor makes managerial decisions concerning performance in the review of variances.

4. Objectivity is impaired in that the internal auditor will be called upon to evaluate the design and implementation of the system in which the auditor played a significant role. Testing of the internal controls would not impair objectivity because

26-20 (continued)

this activity is necessary for determining the adequacy of accounting and administrative controls.

5. Objectivity is impaired. The internal auditors should not be involved in the record keeping process.

c. 1. Yes, the reporting relationship results in an objectivity problem. The controller is responsible for the accounting system and related transactions.

The internal audit staff is responsible for independent and objective review of the accounting system and related transactions. Independence and objectivity may not exist because the internal audit staff is responsible for reviewing the work of the corporate controller, the person to whom it reports.

2. No, the responses for requirement b. would not be affected by the internal audit staff reporting to an audit committee rather than the controller. In order to maintain objectivity, the internal audit staff should refrain from performing non-audit functions such as management decision-making, design and installation of systems, record keeping, etc. Ideally, the internal audit staff should perform only audit functions to avoid being called upon to evaluate its own performance. This is true without regard to organizational reporting relationships.

26-21 a. To help organizations accomplish their objectives, management is responsible for establishing and maintaining a system of internal controls on behalf of the organization's stakeholders and is held accountable for this responsibility. A dedicated, independent, and effective internal audit activity assists both management and the oversight body (e.g., the board, audit committee) in fulfilling their responsibilities by bringing a systematic, disciplined approach to assessing the effectiveness of the design and execution of the system of internal controls and risk management processes.

b. The following are the six steps to certification:

1. Decide which certification is right for you.
2. Determine your eligibility and skill level.
3. Register for the exam.
4. Prepare for the exam.
5. Take the test.
6. Receive your certificate.

26-21 (continued)

c. The following certifications are available:

1. CIA (Certified Internal Auditor)
2. CCSA (Certification in Control Self-Assessment)
3. CFSA (Certified Financial Services Auditor)
4. CGAP (Certified Government Auditing Professional)
5. CRMA (Certification in Risk Management Assurance)
6. BEAC (Board of Environmental Health and Safety Auditor Certification)

d. The three parts of the CIA Exam are:

Part 1 – Internal Audit Basics
Part 2 – Internal Audit Practice
Part 3 – Internal Audit Knowledge Elements

Like the CPA exam, the CIA is a computerized exam, and candidates may also sit for individual sections of the exam. Like the CPA exam, the CIA exam is non-disclosed. Part 1 consists of 125 multiple-choice questions and is 150 minutes in length, and Parts 2 and 3 consist of 100 multiple-choice questions and are 120 minutes in length each. Candidates will forfeit all fees and lose credit for any exam parts previously passed if the certification process is not completed within four years of application approval.

26-22 a. The U.S. Government Accountability Office (GAO) issues *Government Auditing Standards* (GAGAS). The financial auditing standards within GAGAS are consistent with the principles of the AICPA auditing standards. However, GAGAS contain additional standards and modifications related to the following:

- *Materiality and significance*. GAGAS recognize that audit risk and materiality thresholds may be lower in audits of governmental entities than commercial entities.
- *Quality control*. CPA firms that audit government entities must have appropriate systems of quality control and participate in external quality control review programs. Auditors must complete 80 hours of CPE each two-year period with 24 of those hours in subjects related to the government environment and government auditing.
- *Compliance auditing*. GAGAS also require the audit to be designed to provide reasonable assurance of detecting material misstatements resulting from non-compliance with provisions and contracts or grant agreements that have a direct and material effect on the financial statements.

26-22 (continued)

- *Reporting*. The audit report must state that the audit was made in accordance with GAGAS and the report must describe the scope of the auditor's tests of compliance with laws and regulations and internal controls and present the results of those tests or refer to a separate report that includes that information.

b. Because the school system receives over $15 million in federal financial funding, the system would be required to have an audit conducted in accordance with the Single Audit Act. That would require Waggoner and Allen, LLP, to expand the scope of their audit to include additional testing related to programs associated with the federal funding and they would be required to issue additional reports specific to the federal funding received.

c. Thresholds related to materiality and audit risk for the school system may be lower than thresholds in the audit of a commercial entity due to the sensitive nature and close scrutiny of the school system's financial information by taxpayers and the federal government. The auditor is also required to evaluate and test controls related to federal programs and compliance with laws, regulations, and the provisions of contracts or grant agreements related to major programs.

d. GAGAS would require the auditor to include in its report on the financial statements a description of the auditor's tests of compliance with laws and regulations and internal controls and a presentation of the results of those tests (or reference to a separate report). The Single Audit Act would also require the auditor to provide the following:

- An opinion as to whether the schedule of federal awards is presented fairly in all material respects in relation to the financial statements as a whole.
- A report on internal control related to the financial statements and major programs.
- A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, where non-compliance could have a material effect on the financial statements.
- A schedule of findings and questioned costs.

e. If Waggoner and Allen, LLP, accepts this engagement, the auditors involved in planning, performing, or reporting for the engagement must complete 80 hours of continuing professional education in

26-22 (continued)

each two-year period. At least 24 of these 80 hours must be in subjects related to the government environment and government auditing.

26-23 a. Issues that must be addressed by Haskin's Internal Audit Department (IAD) in the audit review of Burlington Plant's 2016 capital expenditure project include the following:

ISSUES
1. The criteria used by the Capital Budgeting Group (CBG) need to be evaluated to determine whether they are consistent with Haskin's long-term goals and objectives.
2. The internal controls in the capital budgeting process need to be evaluated to determine whether the CBG applied the criteria consistently.
3. The ROI (hurdle rate) must be tested for reasonableness to be sure the appropriate projects are selected.
4. The IAD must determine how well the project is now doing as compared to the original analysis.

b. Procedures that should be used by Haskin's Internal Audit Department (IAD) in the audit review of Burlington Plant's 2016 capital expenditure project include the following:

PROCEDURES
1. Review Haskin's long-term goals and objectives to determine the appropriateness of each evaluation criterion being employed by the CBG.
2. Review, test, and evaluate the internal controls associated with the capital budgeting process. This would include a review of the capital budgeting procedures manual, if one exists, and preparing a flowchart for the capital budgeting process.
3. Review how the hurdle rate is determined now and was determined in 2015. Determine if a risk adjustment was incorporated into the decision process by such means as increasing the hurdle rate or decreasing estimated cash flows.

26-23 (continued)

PROCEDURES
4. Interview and evaluate the competence of the available participants in the decision, including the originator of the CBG. Read the minutes of the CBG's meetings and review all status reports for the project from inception through its completion. Review the quantitative analysis used by the CBG to determine if data were valid, assumptions and estimates reasonable, only relevant costs were considered, and cost behavior (fixed and variable) was correctly perceived.
5. Review Haskin's internal accounting controls to assure that all acquisition and installation costs for the machines are capitalized and that operating and maintenance costs for the machines are recorded accurately and expensed. Review documents related to the acquisition of other machines and determine the actual amount of investment. Review accounting, maintenance, and production records, and other documentary evidence, to determine actual operating costs and actual contribution for each machine.

26-24

a. DEFICIENCIES/ INEFFICIENCIES	b. RECOMMENDATIONS
1. Quantities of materials received are not verified by the materials manager.	Besides inspecting all incoming goods to ensure that quality standards are met, the materials manager should verify quantities received by actual physical count. All material receipts do not have to be counted for a verification program to be effective. Systematically verifying one or several receipts from each vendor during a given time period can identify those receipts that are the most troublesome. Once identified, efforts can be directed to correcting the problem. The verification process is performed by comparing receiving document quantities to actual physical counts to ensure invoice totals are correct.

26-24 (continued)

a. DEFICIENCIES/ INEFFICIENCIES	b. RECOMMENDATIONS
2. The materials manager prepares purchasing requests based on production schedules and not on requisitions received from operating departments.	Purchasing requests prepared by the materials manager are to be based on requisitions received from operating departments and not production schedules for a four-month period. Production schedules could be outdated and not reflect current sales trends. Operating departments are constantly adjusting production levels to account for changes. To improve budgetary control over expenditures, the controller's office also should review the requests in conjunction with forward planning to ensure expenditures are consistent with company sales projections. Once an analysis of inventory flows is complete the economic order quantity can be applied to determine the reorder point and to minimize inventories.
3. The majority of Lecimore's requirement for a critical raw material is supplied by a single vendor.	It is best to develop alternate sources of supply for critical materials. The obvious benefits are reduced reliance on a single vendor, and the reduced possibility of lost production because of material shortages and/or other interruptions in the operation due to a single vendor. Encouragement of competition by the effective allocation of material requirements between vendors is also another benefit that can be expected to materialize if an effective program is implemented. Other benefits such as improved vendor services and technical assistance may also result as vendors attempt to gain increased shares of the goods provided the user company.
4. Rush and expedite orders are made by production directly to the purchasing department without consulting the materials managers.	Rush and expedite orders should be reviewed by the materials manager to determine if any of the orders can be filled using existing inventories.

26-24 (continued)

a. DEFICIENCIES/ INEFFICIENCIES	b. RECOMMENDATIONS
5. The purchasing department is held responsible for the cost of special orders, which can be clearly identified by requesting departments.	The direct association of special order costs with responsible departments is necessary in order to exercise proper control. Responsibility accounting obligates departments to exercise judgment and prudence over those costs they are held accountable for. Through responsibility reporting, excessive costs are highlighted so that corrective actions can be implemented.
6. Engineering changes are not discussed with other departments before the materials needed to implement the change are ordered.	A general policy outlining the authority and responsibility for implementing engineering changes must be established. The proposed changes should be reviewed thoroughly by various company departments before an order is placed. The controller's office would review the proposal in light of incremental costs or cost savings that are expected to result. The manufacturing departments would review the change from an adaptability point of view. Before placing an order, purchasing would have to receive approval from the reviewing departments. Once approval is obtained, the vendor selection process can begin.
7. Accounting is not notified by the materials manager of the receipt of partial shipments.	Besides notifying the purchasing department of the receipt of partial shipments, the materials manager should also inform the accounting department so that vendor invoices can be processed correctly. Receiving reports clearly identifying the receipt as a partial shipment is the most effective means of communicating this information. By appropriately annotating the receiving report, vendors will not be paid for materials the company has not received.

26-25

DEFICIENCIES	RECOMMENDATIONS
1. An authorization document that describes the item to be acquired, indicates the benefits to be derived, and estimates its cost is not prepared and reviewed with management.	To obtain approval for the purchase of machinery and equipment, an appropriations request should be prepared, describing the item, indicating why it is needed, and estimating its expected costs and benefits. The document also could include the item's accounting classification, expected useful life, depreciation method and rate, and the names of approving company executives.
2. There is no control over authorized acquisitions. The purchase requisitions and purchase orders for fixed assets are interspersed with other requisitions and purchase orders and handled through normal purchasing procedures.	Authorized acquisitions should be processed using special procedures and purchase orders. These purchase orders should be subjected to numerical control. Copies of purchase orders should be distributed to all appropriate departments so that the acquisition can be monitored.
3. Plant engineering does not appear to be inspecting machinery and equipment upon receipt.	Purchases of machinery and equipment should be subject to normal receiving inspection routines. In the case of machinery and equipment, plant engineering is usually responsible for reviewing the receipt to make certain the correct item was delivered and that it was not damaged in transit. All new machinery and equipment would be assigned a control number and tagged at the time of receipt.
4. The lapse schedules are not reconciled periodically to general ledger control accounts to verify agreement.	At least once each year, machinery and equipment lapse schedules, which provide information on asset cost and accumulated depreciation, should be reconciled to general ledger control accounts. Furthermore, an actual physical inventory of existing fixed assets should be taken periodically and reconciled to the lapse schedules and general ledger control account to assure accuracy.
5. Machinery and equipment accounting policies, including depreciation, have not been updated to make certain that the most desirable methods are being used.	Machinery and equipment accounting procedures, including depreciation, must be updated periodically to reflect actual experience, and changes in accounting pronouncements and income tax legislation.