Guide to fraud in governmental and not-for-profit environment

Lynda M. Dennis

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This revised edition is designed to provide you with an overview of specific challenges that you will face when performing a fraud engagement for government and not-for-profit entities. The content is intended to assist you in planning and performing a fraud engagement as well as responding, documenting, and reporting fraud in these environments. Features of this book include the following:

- The unique operational, financial reporting, and accounting principles of government and not-for-profit organizations provide you with the fundamental knowledge you will need in a fraud engagement for these types of entities.

- An in-depth treatment of SAS No. 99 focuses on the unique aspects of a fraud engagement for government and not-for-profit entities and explores the different circumstances in which you will apply the auditing standard to your engagement.

- Review questions and case examples help you apply the concepts discussed in each chapter in real world scenarios.

- Appendixes containing sample excerpts from Government Auditing Standards and sources of additional information provide guidance on collecting the appropriate reference material you will need to perform your engagement.
Guide to Fraud in Governmental and Not-for-Profit Environments

Lynda M. Dennis, Ph.D. CPA, CGFO
Notice to Readers

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Guide to Fraud in Governmental and Not-for-Profit Environments

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About the Author

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Her experience includes serving in a financial capacity, including chief financial officer, in governmental and not-for-profit organizations primarily in Florida. Her experience also includes working as an auditor for local and Big Four firms with an emphasis in the insurance, government and not-for-profit sectors. Lynda also worked as the Special Projects Manager for the Dallas County Community College District and as a grader of CPA exams for the AICPA.

Lynda actively participates in committee and other volunteer work for the AICPA and FICPA and is a frequent speaker at governmental accounting conferences. She has previously published a CPE course on fraud as well as a book on strategy implementation (both for governmental and not-for-profit organizations) for the AICPA and a public finance primer for the American Public Works Association. Currently, she is working on a book related to internal controls in governmental organizations and a CPE course on fraud case studies for the AICPA.
Preface

Introduction

In the early years of the twenty-first century, the accounting profession experienced some of its darkest days since the 1938 McKesson-Robbins corporate accounting scandal. Massive scandals at Enron, WorldCom, and Global Crossing put all CPAs in the spotlight whether they were auditors of publicly traded companies or small closely held family corporations. To protect the American public against such spectacular failures in the future, President George W. Bush signed the Sarbanes-Oxley Act into law in the summer of 2002.

It is interesting to note that while Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit, (hereafter referred to as SAS No. 99) was released after the passage of the Sarbanes-Oxley Act; it was not issued in response to the failures giving rise to its passage. SAS No. 99 was the result of a four year process that began with five academic research studies conducted as part of the AICPA Fraud Research Steering Task Force. In addition to these studies, the Public Oversight Board, at the request of the Securities and Exchange Commission, appointed a Panel on Audit Effectiveness in 1998. This Panel conducted its own research primarily related to audit effectiveness and issued a report in August of 2000.

**Note:** The full version of SAS No. 99 can be found by visiting the AICPA Forensic Accounting and Valuation Services website. Search: SAS No. 99, Consideration of Fraud in a Financial Statement Audit.

Using these studies and other information, the AICPA Fraud Task Force established in September of 2000, reviewed SAS No. 82, Consideration of Fraud in a Financial Statement Audit, and concluded it was fundamentally sound. The recommendations of this task force to enhance professional auditing standards related to fraud were incorporated in the exposure draft issued February 28, 2002, which was adopted as SAS No. 99 in October of 2002.

Fraud has become a major focus among not only financial statement users but also among many Americans in their roles as investors, watch dogs, philanthropists, or private citizens. In the last 20 years, news reports have often revealed fraud and abuse at all levels of governmental and not-for-profit organizations. The national level United Way scandal of the early 1990s had a significant negative impact on many local United Way agencies. Americans were outraged to learn the Federal government had spent thousands of dollars for items found at the local building supply store for less than $100.

Individuals and businesses contributing to not-for-profit organizations have a legitimate expectation that their donations will be used to further the mission of the not-for-profit organization. When such funds are at best, diverted for other uses, or worst case, appropriated for
personal gain, the reputation of the not-for-profit organization is jeopardized. In such cases, the lack of trust potential individual and corporate donors have in the not-for-profit organization can seriously impact its revenues and, correspondingly, its continued existence.

For citizens, fraud in governmental organizations is a misuse of the public funds they provided to the government without choice and in good faith. Such breaches of trust further erode their tenuous faith in the “American Way” and needlessly increase the cost of providing public goods and services. Simply put, everyone loses when fraud occurs in governmental organizations.

This book is designed to give auditors and accounting and finance professionals a working knowledge of SAS No. 99 and its unique applications in the governmental and not-for-profit environment. It is also intended to assist the auditor of governmental and not-for-profit organizations in planning and performing their audit as well as in responding, documenting, and reporting fraud. An understanding of the governmental and not-for-profit environment, coupled with a thorough knowledge of the requirements of SAS No. 99, improves the likelihood the auditor will detect material financial statement misstatements due to fraud.

This book will help you to:

- Identify the unique situations that exist in governmental and not-for-profit organizations that create or increase the potential for fraud.
- Understand how objectives of financial reporting and the users of financial statements for governmental and not-for-profit organizations differ from those in the private sector and how such differences need to be addressed in planning and performing the audit.
- Obtain a thorough understanding of the requirements of SAS No. 99 and how they impact the audits of governmental and not-for-profit organizations.
- Integrate all aspects of the requirements of SAS No. 99 in the audits of governmental and not-for-profit organizations from identification of fraud risks through documentation and communication of fraud and fraud risks.
- Apply specific professional standards to fraudulent financial reporting and misappropriation of assets using case studies in governmental and not-for-profit audit engagements.
- Apply specific professional standards to responding, documenting, and reporting fraud using case studies in governmental and not-for-profit audit engagements.

**Organization**

This book deals with AICPA auditing standards related to fraud in audits of governmental and not-for-profit organizations. To that end, the materials are organized into the following chapters:

- *Chapter 1* provides an overview of the governmental and not-for-profit environments focusing on the unique operational, financial reporting, and accounting principles of these organizations. Special emphasis is placed on how these differences impact audit planning and procedures related to fraud.
• Chapter 2 summarizes the audit standards set forth in SAS No. 99 related to fraud considerations in financial statement audits.

• Chapter 3 delves into how the requirements of SAS No. 99 relate to audits of governmental and not-for-profit organizations and how these standards can be incorporated in planning and performing audits of these organizations.

• Chapter 4 delves into specific areas of concern related to fraudulent financial reporting in governmental and not-for-profit organizations. Case studies are used to apply these specific concepts of SAS No. 99 to audits of governmental and not-for-profit organizations.

• Chapter 5 explores specific areas of concern related to misappropriation of assets in governmental and not-for-profit organizations. Case studies are used to apply these specific concepts of SAS No. 99 to audits of governmental and not-for-profit organizations.

• Chapter 6 covers other matters related to fraud in governmental and not-for-profit organizations.

• Appendices include practice aids and professional publications to aid in audits of governmental and not-for-profit organizations.

Summary

This book is designed to provide auditors of governmental and not-for-profit organizations an overview of the specific challenges they face in applying professional standards related to fraud to audits of these entities. Additionally, this book provides a number of suggested practices, procedures, and practice aids to assist auditors in implementing professional auditing standards related to fraud in governmental and not-for-profit organizations.

Conclusion

It is hoped that these book materials prove useful primarily to auditors of governmental and not-for-profit organizations but also to those accounting and finance personnel employed in such organizations.

Throughout the text, the terms he and she are used alternately and no discrimination or implications related to either gender are intended. Additionally, the materials, including the appendices, have been developed using the professional and industry standards, practices, and procedures in effect at the time of the writing. Auditors and other professionals should consult current authoritative guidance in addition to these materials.
Chapter 1
The Governmental and Not-for-Profit Environments

Chapter Objectives
This chapter will discuss the following:

- Identify the unique situations that exist in governmental organizations and not-for-profit organizations that create or increase the potential for fraud.
- Understand how objectives of financial reporting and the users of financial statements for governmental organizations and not-for-profit organizations differ from those in the private sector and how such differences need to be addressed in planning and performing the audit.

Unique Aspects of the Governmental Environment
Public sector, governmental organizations are very different from their private sector counterparts in a number of ways despite current rhetoric to run government like a business. They also differ from not-for-profit organizations, which is why these materials discuss their various characteristics in two separate sections.

Generally, the unique aspects of governmental organizations are as follows:

- They are public organizations.
- They provide goods and services to the general public using funds typically secured from involuntary resource providers.
- Decisions are made in a political environment.
- Goods and services are generally provided without a profit motive.

Government in the Sunshine
The primary distinguishing characteristic of governmental organizations is that they are public organizations. Their very nature requires that business be conducted in view of the public. It is this very simple aspect on which the financial reporting objectives of governmental financial statements rest. Public governmental organizations differ fundamentally from publicly traded entities even though publicly traded companies are subjected to a high level of regulation and public scrutiny.
In some states, state and local governments are required to operate “in the sunshine” for all meetings in which decisions are to be made that do or may impact the public. This requirement to conduct business in a public forum is often a significant impediment to timely responses to sensitive issues. While billions of shares of Microsoft stock are traded annually, the Audit Committee is allowed to meet behind closed doors. In contrast, the city council of a small rural town in North Florida, serving as an audit committee, must meet in a public forum. Not only is the City Council of this small Florida town required to meet in full view of the public but also to adequately and timely publish notice of such meeting and to provide minutes of the meeting to the public.

**Public Goods and Services**

The *second most distinguishing characteristic* of governmental organizations relates to their being public organizations and is that they provide *goods and services that benefit the public at large*. Such public goods and services are provided, in most cases, without regard to how much is paid by those receiving the goods or services. Even in cases where the governmental organization intends to recover its costs with user fees, not all costs are included in determining the fee structure. Often high cost, limited use, and limited or non-revenue producing capital assets are needed to provide public goods and services.

To fund the provision of public goods and services, governmental organizations (in most states) are authorized to impose taxes at a number of levels and on a variety of items. This places individuals and businesses in the position of involuntary resource providers.

A variety of legal constraints and controls exist at all levels of government to ensure the resources involuntarily provided by individuals and businesses are expended for the public good. Typically, the budget process in governmental organizations is the most public manifestation of accountability from a fiscal, operational, and planning perspective. Governmental organizations are directly accountable to citizens, taxpayers, and business owners as well as society at large. The annual audit of a governmental organization’s financial statements is the most visible evidence of its fiscal accountability.

There is tremendous *pressure on employees of governmental organizations to provide more and better public goods and services* using less financial, human, and capital resources. Often, administrative functions such as accounting, internal audit, and procurement *lack sufficient staff to implement or administer an effective system of internal accounting controls*. In addition, many small and medium sized governmental organizations *lack the financial resources to attract qualified accounting and finance personnel.*

**Political Process**

A *third distinguishing characteristic* of governmental organizations relates to providing public goods and services as well as operating in the public and it is the *political process*. The political process varies by type, size, and nature of government but in all cases places constant pressure on elected officials and other policy makers. Elected officials may feel pressure from citizens, special interest groups, other governments, or unfunded governmental mandates. In some cases,
elected officials make decisions that are politically correct but not necessarily economically viable or operationally feasible.

Elected officials are often hesitant to increase taxes even though citizen demands for public goods and services increase. Such reluctance to adequately fund service needs results in governmental employees being forced to provide more goods and services with fewer financial, human, and capital resources. Over time this approach can erode the tax base and infrastructure of a governmental organization as well as negatively impact employee morale.

**Lack of a Profit Motive**

A *final distinguishing characteristic* of governmental organizations is the *lack of a profit motive* which is related to the public goods and services they provide and sometimes the political process. Governmental organizations are in the business of providing goods and services that benefit the public or that typically are not provided by private markets but considered to be in the public interest.

Goods and services provided by governmental organizations are often made available to the public at little or no charge such as recreation services. Other goods and services, such as emergency rescue/transport services, have fee structures with little or no relationship to the benefit received by the consumer or the cost incurred by the governmental organization.

Costs associated with providing some goods and services, such as utilities, are intended to be recovered in full with appropriate user fees. However, there is wide disparity in the costs governmental organizations consider recoverable through utility user fees. For example, some governmental organizations allocate all, or a portion of all, costs of the government to utility operations while others allocate only those directly or indirectly associated with utility operations.

**Unique Aspects of the Not-for-Profit Environment**

Statement of Financial Accounting Standards (SFAS) No. 116, *Accounting for Contributions Received and Contributions Made*, defines not-for-profit organizations for purposes of preparing financial statements in accordance with generally accepted accounting principles. SFAS No. 116 distinguishes a not-for-profit organization from a business enterprise based on the following characteristics:

- *Significant amounts of contributions* of resources are received from resource providers not expecting commensurate or proportionate financial return,
- The organization *operates for purposes other than to provide goods or services at a profit, and*
- *Ownership interests* such as those found in business enterprises are absent.

The AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*, further defines not-for-profit organizations as
Not-for-profit organizations defined in SFAS No. 116; and

Entities defined in AICPA Statement of Position No. 74-8, Financial Accounting and Reporting by Colleges and Universities; and,

Organizations identified in Statement of Position No. 78-10, Accounting Principles and Reporting Practices for Certain Nonprofit Organizations.

Entities falling within these guidelines differ from for-profit entities not simply from a definitional perspective, but also from their distinctive organizational and operational characteristics.

**Significant Contributions**

In order to fund goods or services provided to the community for little or no cost, not-for-profit organizations have traditionally relied on contributions from individuals and businesses. Such contributions are often significant to the total resources available to the not-for-profit organization. To meet the criteria of a contribution delineated in SFAS No. 116, individuals or businesses must make their contributions with no expectation of financial or other remuneration.

Contributions received by a not-for-profit organization may be subject to donor restrictions imposing time or use restrictions either on a temporary or permanent basis. Such contributions are required to be classified as restricted until the restriction has been lifted or satisfied. Not-for-profit organizations often receive contributions in the form of grants from governmental agencies or other not-for-profit organizations. These grants are typically restricted for a particular program of the benefiting not-for-profit organization. In some cases, grants are used to fully or partially offset the cost of providing goods or services to the community at little or no charge.

Valuable and sometimes significant services are contributed on behalf of, or for the benefit of, the not-for-profit organization or the clients it serves. These services may take the form of professional services (i.e., legal, accounting, auditing, architectural, or engineering) or trade services (i.e., electrical, plumbing, maintenance) and would typically be paid for by the not-for-profit organization if not donated by the service providers. Depending on the type of contributed services, they are required to be either recorded in the financial statements or disclosed in the notes to the financial statements.

A variety of legal constraints and controls exist to ensure the resources provided voluntarily by individuals and businesses are used for the purposes they specified or to further the mission of the not-for-profit organization. Grant provisions often require a significant amount of control over and accountability for funds disbursed to not-for-profit organizations. In many cases, the annual audit of a not-for-profit organization’s financial statements is the most visible evidence of its fiscal accountability. Rules and regulations of the Internal Revenue Service related to tax exempt organizations also act as constraints and controls over contributions received by a not-for-profit organization.
Lack of a Profit Motive

Not-for-profit organizations are organized for and operated to achieve a particular mission rather than to make a profit from their operations. It is this dedication to mission that drives the operations of most not-for-profit organizations. To this end, the financial statements of a not-for-profit organization reflect expenses on a functional basis rather than their natural line-item type classifications. (Note. Voluntary health and welfare organizations are required to present both natural and functional expense information.) Additionally, the mission of a not-for-profit organization is what makes it a qualified tax exempt organization under the Internal Revenue Code.

With a high level of focus on mission, administrative functions such as accounting, internal audit, and procurement are often ignored or seen as unnecessary. Therefore, not-for-profit organizations often lack sufficient staff to implement or administer an effective system of internal accounting controls. In addition, many small and medium sized not-for-profit organizations lack the financial resources to attract qualified accounting and finance personnel.

In furtherance of their missions, not-for-profit organizations typically provide goods and/or services to the community in many cases, without regard to how much is paid by those receiving the goods or services. Even in cases where the not-for-profit organization intends to recover its costs with fees/charges not all costs are included in determining the fee structure. Additionally, there is wide disparity in the costs not-for-profit organizations consider recoverable through client charges and fees.

Often not-for-profit organizations confuse the lack of a profit motive with not being allowed to generate a profit. Not-for-profit organizations are a business and should therefore consider typical business strategies like adequately covering costs with fees/charges. Simply because they are not profit motivated does not excuse the not-for-profit organization from acting prudently and exercising sound business judgment.

It is not the existence of a positive bottom line that differentiates not-for-profit organizations from entities in the private sector but rather the function of the “bottom line.” The not-for-profit organization uses excess profits to further its mission while for profit entities distribute excess profits to owners and/or for private gain. If not-for-profit organizations were not expected to make a “profit,” why would they generally be exempt from federal taxation?

Ownership Interests

Because not-for-profit organizations do not have stockholders, the equity in the not-for-profit organization is represented by its net assets. Owners of for profit entities have a viable interest in the equity of their entity. As such, they exercise control over the entity in order to protect their equity interest. There are no “owners” of the typical not-for-profit organization and therefore no “owners” exist to protect the net assets of the not-for-profit organization.

In some states the net assets of a not-for-profit organization are protected through incorporating documents or other legal means. The Internal Revenue Service requires the articles of incorporation for newly recognized tax exempt organizations to include the following language in an effort to protect the net assets of the not-for-profit organization:
Upon dissolution of the Corporation, assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)3 of the Internal Revenue Code, or the corresponding section of any future Federal tax code, or shall be distributed to the Federal government, or to a state or local government, for a public purpose. Any such assets not so disposed of shall be disposed of by a Court of Competent Jurisdiction of the county in which the principal office of the Corporation is then located, exclusively for such purposes or to such organization or organizations, as said Court shall determine, which are organized and operated exclusively for such purposes.

**Other Differences**

Another challenge for auditors of not-for-profit organizations is that not-for-profit organizations differ among themselves even when they have the same or similar mission. For example, a not-for-profit organization may be a museum in a highly populated metropolitan area or a small church in the rural south, both of which provide different services and serve vastly different populations with diverse needs. Likewise, two not-for-profit hospitals may differ in the services they provide because of their geographic location, the populations they serve, bed capacity, plant and equipment, etc. The auditor of not-for-profit organizations must understand not only the differences between not-for-profit organizations and private sector entities but the differences between various not-for-profit organizations.

These differences make it necessary for the auditor to consider fraud in the financial statements of a not-for-profit organization differently than that of an audit of a for profit organization.

**Governmental Financial Reporting Objectives and Users**

**Governmental Financial Reporting Objectives**

Financial reporting objectives of governmental financial statements reflect the needs of the users. The needs of these financial statement users differ in a number of ways than users of private sector financial statements.

Concepts Statement No. 1, *Objectives of Financial Reporting*, of the Governmental Accounting Standards Board (GASB) identifies the objectives of external financial reporting by state and local governments. These objectives include the following:

- To fulfill the governments obligation to be publicly *accountable* and enable users to assess accountability in the following areas:
  - Sufficiency of current revenues to finance current year services;
  - Compliance with the legally adopted budget and other finance-related legal/contractual requirements; and,
  - Service efforts, costs, and accomplishments of the governmental organization.

- To satisfy needs of financial statement users relying on governmental reports as important sources of *information for decision making* related to
  - Evaluating operating results for the fiscal period and
  - Assessing level of services that can be provided by the government and its ability to meet obligations as they become due.
Public accountability presumes taxpayers are entitled to know what their governments are doing and how, what they have done and how well, and what they plan to do and why. Citizens as well as legislative and oversight bodies almost universally use financial reporting to assess accountability in their governmental organizations.

Financial reporting is the primary channel through which governmental organizations communicate financial information to external users of the financial reports. Therefore, financial reporting by governmental organizations considers the needs of these users and the decisions they make. In addition, financial reports of governmental organizations should be

- Understandable.
- Reliable.
- Relevant.
- Timely.
- Consistent.
- Comparable.

Governmental financial reports are used in decision making and in assessing accountability. Decision making encompasses not only economic decisions but social and political decisions as well. Accountability forces governmental organizations to answer to its citizens and to justify to them the need for public resources as well as the intended and actual use of said public resources. Underlying public accountability is the concept of intergenerational or interperiod equity which suggests that current citizens should not shift the burden of financing current services to subsequent year taxpayers.

Some ways in which governmental financial reports are used for decision making and assessing accountability include

- Comparing actual financial results with amounts in legally adopted budgets.
- Assessing financial condition and operating results.
- Determining compliance with finance-related laws, rules, and regulations.
- Evaluating efficiency and effectiveness.

Financial reporting by governmental organizations includes both general and special purpose reporting. General purpose financial reporting by governmental organizations includes

- General purpose external financial statements.
- Popular reports.
- Comprehensive annual financial reports (CAFRs).

Other types of financial reporting may include voluntary or required reporting of selected financial and/or operational information intended to satisfy the specific needs of specific users. The objectives of such special purpose reports are to

- Meet specific legal or contractual requirements.
- Present financial information using a basis of accounting other than generally accepted accounting principles.
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- Present financial information in prescribed formats.
- Report on specific elements, accounts, or items included in the general purpose financial statements.

Typically, such special purpose financial reporting include
- Bond offering statements.
- Operating and capital budgets.
- Grant reports.
- Reports required by regulatory agencies.

Users of Governmental Financial Reports

Governmental financial reports are used internally as well as externally to make decisions or to ensure public accountability. Three primary users of external governmental financial reports are
- Citizens – Those to whom governmental organizations are primarily accountable.
- Legislative and oversight bodies – Those directly representing citizens.
- Investors and creditors – Those lending or participating in the lending process, including grantors.

Users of government financial reports assess accountability through traditional measures such as actual to budget comparisons; assessment of financial condition; and, compliance with laws, rules, and regulations. Additional non-traditional uses of financial reporting include assisting users in evaluating efficiency and effectiveness.

Internal management having access to financial information using internal channels is not considered a primary user of financial reports. Such internal users often use both internal and external reports for
- Decision making – Current and long term recommendations for operating and capital purposes.
- Planning – Related to strategic initiatives such as comprehensive capital improvement plans and strategic plans as well as day-to-day and long-term operations.
- Monitoring – Compliance with budget, achievement of program objectives, operating performance, etc.

Not-for-Profit Financial Reporting Objectives and Users

Not-for-Profit Financial Reporting Objectives

Financial reporting objectives of not-for-profit financial reports focus on decisions generally made by resource providers for the following reasons:
- Resource providers are important users of financial reports even though they do not have the ability to prescribe information they want to see in financial reports.
• Decisions made by resource providers significantly affect not-for-profit organizations as well as the allocation of resources in society overall.

• Information meeting the needs of current and future resource providers is likely to be of interest to others involved in basically the same issues as resource providers.


• Broadly focusing on information useful to resource providers and others in making rational resource allocation decisions.

• Narrowing to the information needs of resource providers and others related to services provided by not-for-profit organizations and their ability to continue to provide such services.

• Wrapping up with the types of information financial reporting by not-for-profit organizations can provide to meet these needs.

Generally, financial reports provide information useful in making decisions regarding the allocation of scarce resources but they do not determine what those decisions should be. Therefore, specific objectives of financial reporting by not-for-profit organizations identified in Concepts Statement No. 4 are to

• Provide present and potential resource providers and other users with *information useful in making rational decisions regarding allocating resources* to those organizations.

• Provide present and potential resource providers and other users with information for use in assessing services provided by the not-for-profit organization and its ability to continue providing these services.

• Provide present and potential resource providers and other users with information for use in assessing how management of the not-for-profit organization discharged its stewardship responsibilities as well as other aspects of their performance.

• Provide information about
  – Economic resources, obligations, and net resources to help users:
    ▪ Identify financial strengths and weaknesses.
    ▪ Evaluate information about organizational performance.
    ▪ Assess the not-for-profit organization’s ability to continue to provide services.
  – Organization performance:
    ▪ Nature of and relation between inflows and outflows of resources during the period.
    ▪ Service efforts and accomplishments to help users assess organizational performance and in making decisions regarding resource allocations.
  – Liquidity.
• Management’s explanations and interpretations to help users understand the financial information provided.

Financial reporting for not-for-profit organizations reflects not only its objectives but their unique organizational and operational characteristics as well. While the basic financial statements prepared by not-for-profit organizations are similar to those prepared by for profit entities, the information presented is intended to meet the objectives of vastly different users.

Not-for-profit organizations prepare their financial reports using the guidance of SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*. Information reported in basic financial statements under SFAS No. 117 is not required to be presented by individual funds or fund groups. Therefore, SFAS No. 117 does not use the terms fund balance or changes in fund balance because they do not represent net assets or changes in net assets for not-for-profit organizations.

To provide relevant information about a not-for-profit organization’s assets, liabilities, and net assets and their relationships to each other, amounts are reported by asset class. The three classes of net assets typically found in a not-for-profit organization are

• Permanently restricted net assets.
• Temporarily restricted net assets.
• Unrestricted net assets.

**Users of Financial Reports of Not-for-Profit Organizations**

Financial reports of not-for-profit organizations are used internally as well as externally to make decisions and/or to assess information about services provided by the not-for-profit organization. Three primary users of external financial reports of not-for-profit organizations are

• *Resource providers* – Includes those that are directly compensated for providing resources (i.e., lenders, vendors, employees, etc.) and those not directly and proportionately compensated for providing resources (i.e., members, donors, taxpayers, etc.).
• *Constituents* – Those who use and benefit from services provided by the not-for-profit organization.
• *Governing and oversight bodies* – Those responsible for establishing policies and for overseeing and evaluating management of not-for-profit organizations [i.e., boards of directors/trustees, legislatures (Federal, state, local), councils, national headquarters, accrediting agencies, governmental regulatory agencies, etc.].

The various users of financial reports of not-for-profit organizations are commonly interested in the following areas:

• Information regarding the services provided by a not-for-profit organization.
• How efficient and effective the not-for-profit organization was in providing those services.
• The ability of the not-for-profit organization to continue providing those services in the future.
In addition to the shared concerns, the individual primary external users of the financial reports of not-for-profit organizations have specific areas of interest. Some of the issues specific to particular external users of these financial reports are as follows:

- **Resource providers**, such as donors, may be interested in information indicating how well the not-for-profit organization met its objectives and whether to continue their support of the not-for-profit organization. On the other hand, resource providers such as lenders and vendors are concerned with the ability of the not-for-profit organization to generate cash flow sufficient to timely pay obligations to them.

- **Constituents**, like resource providers, are interested in whether or not the not-for-profit organization is able to continue providing services in the future and if so, at what cost to constituents.

- **Governing and oversight bodies** use information in financial reports to determine whether management carried out policy mandates with which they were charged. They also use this information to change and/or develop new policies.

*Internal management*, and to an extent governing bodies, have access to financial and other information needed for decision making using internal channels. Therefore, management is not considered a primary user of financial reports. Such internal users often use both internal and external reports to carry out their responsibilities for

- Planning and controlling activities.
- Ensuring resources are used for their intended purposes.
- Complying and/or overseeing compliance with spending mandates of budgetary appropriations or donor or grantor restrictions.

**Summary**

This chapter provided insight into the unique aspects of governmental organizations and not-for-profit organizations that may represent potential fraud risks in financial statement audits. In addition, this chapter focused on the influence financial reporting objectives and users may have on the auditor’s assessment of fraud risks.
Review Questions

1. What are the major aspects differentiating governmental organizations from those in the private sector?

2. What are the major aspects differentiating not-for-profit organizations from those in the private sector?

3. Who are the primary users of external governmental financial reports?

4. Who are the primary users of external not-for-profit financial reports?
Chapter 2

Professional Standards: Concepts, Requirements, and Conflicts

Chapter Objectives

This chapter will discuss the following:

- Recognize the expectation gap related to the auditor’s professional responsibilities for fraud and expectations of the market place.
- Identify the conditions delineated in the fraud triangle.
- Understand the auditor’s responsibilities related to fraud under SAS No. 99.

Auditor Responsibilities and Market Place Expectations

Under the guidance established with Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures (as amended by SAS No. 104)*, auditors must plan and perform the audit to obtain sufficient appropriate audit evidence so that audit risk will be limited to a low level; that is, in his or her professional judgment, appropriate for expressing an opinion on the financial statements. The high, but not absolute, level of assurance that is intended to be obtained by the auditor is expressed in the auditor’s report as obtaining reasonable assurance about whether the financial statements are free of material misstatement (whether caused by error or fraud). Due to the nature of evidential matter obtained in an audit engagement and the characteristics of fraud, it is not possible for the auditor to obtain absolute assurance with respect to material misstatements in the financial statements.

Unfortunately, the concept of *reasonable assurance* is not one that has been easily understood by clients of CPAs. In some cases, clients and financial statement users mistakenly believe the auditor’s primary responsibility in a financial statement audit is the detection of fraud. Because of this *expectation gap* businesses, as well as governmental and not-for-profit organizations, may tend to postpone implementation of, or ignore completely, the need for effective internal controls.

Auditors might reasonably presume the expectation gap to occur with their smaller or less sophisticated clients. However, a survey conducted by the AICPA soon after the passage of the Sarbanes-Oxley Act of 2002 indicated the expectation gap also exists with sophisticated business decision makers and investors/shareholders. Based on over 1,000 interviews with such individuals, over 80% of this presumably knowledgeable group believed the job of the external auditor was to prevent fraud!
Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*, establishes guidance relating to the auditor’s responsibility with respect to material misstatements caused by fraud and supersedes previously issued standards related to the consideration of fraud in financial statement audits. While this standard does not change the overall auditor responsibility with respect to fraud, nor may it decrease the expectation gap, it does require auditors to change how they plan and conduct financial statement audits with respect to the detection of fraud.

**The Fraud Triangle**

Conditions under which fraud generally occurs are delineated in SAS No. 99 as the “fraud triangle.” These three conditions are

- **Incentive or pressure** – Placed on or perceived by management and/or employees typically providing them a reason to commit fraud.
- **Opportunity** – Circumstances existing within a particular entity providing opportunities for the perpetration of fraud.
- **Rationalization or attitude** – Attitudes, character, or ethical values of particular individuals allowing them to rationalize committing fraud or some other dishonest act.

A combination of these conditions frequently exists in the private sector but is far more likely in most governmental and not-for-profit organizations. For example, governmental and not-for-profit organizations operate with and/or compete for scarce resources while striving to maintain or increase service levels creating *incentive or pressure* conditions. Many small and medium governmental and not-for-profit organizations have limited administrative personnel who often lack sufficient knowledge and/or skills to implement and administer an effective system of internal controls which in turn creates fraud *opportunities*. Employees in governmental and not-for-profit organizations may *rationalize* dishonest acts because they are often paid less than individuals in the private sector. The prevalence of these conditions comprising the fraud triangle increases the risk of fraud in governmental and not-for-profit organizations.

Research indicates the potential for material fraud exists in the American workplace. According to a 2003 survey sponsored by Ernst & Young LLP, 20% of American workers are personally aware of fraud in the workplace. Respondents to this survey estimated employers lost 20% of every dollar to some type of workplace fraud and were personally aware of fraud due to the following:

- Theft of office items.
- Claiming extra hours worked.
- Expense accounts.
- Taking kickbacks from suppliers.
Requirements under SAS No. 99

CPAs have been responsible for opining that financial statements are presumed to be free of material misstatement due to error or fraud long before SAS No. 99. The intent of SAS No. 99 is to improve the likelihood auditors will detect such misstatements in the financial statements caused by fraud. However, if collusion among management, employees, and/or third parties exists, even an auditor that has properly performed the audit may erroneously conclude the financial statements are free of material misstatements due to fraud.

Fraud Defined

Auditors consider fraud in the context of material misstatements in financial statements rather than from a legal perspective. SAS No. 99 distinguishes fraud from error based on intent and defines fraud as

“…an intentional act that results in a material misstatement in financial statements that are the subject of an audit.”

Misstatements relevant to an auditor’s consideration of fraud arise from

- **Fraudulent financial reporting** – Intentional misstatements or omissions (amounts or disclosures) designed to deceive financial statement users.

- **Misappropriation of assets** – Theft of an entity’s assets.

Tip: It may be helpful to discuss the differences between legal and accounting fraud with staff and/or client personnel. In some cases, staff and/or clients may approach fraud in its legal rather than accounting definition.

Fraudulent Financial Reporting

Fraudulent financial reporting does not necessarily result from a grandiose plan to deceive financial statement users. Management may simply rationalize material misstatements as an aggressive interpretation of complex accounting issues or as temporary misstatements expected to be corrected when operations subsequently improve. Such fraudulent financial reporting often results from management override of existing controls and it may be difficult to detect because management

- Withholds evidence.

- Misrepresents information in response to auditor inquiries.

- Falsifies documents.

Other more elaborate fraudulent financial reporting schemes may be accomplished through any or all of the following:

- **Manipulation, falsification, or alteration** of accounting records or supporting documentation.

- **Misrepresentations or intentional omissions** related to
Guide to Fraud in Governmental and Not-for-Profit Environments

- Events.
- Transactions.
- Other significant information.

- Intentional misapplication of accounting principles relating to
  - Amounts.
  - Classification.
  - Manner of presentation.
  - Disclosure.

Many of the requirements of SAS No. 99 are supported by the findings of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. This research found the methods of fraudulent financial reporting fell into the following broad categories:

- Earnings manipulation.
- Earnings management.
- Balance sheet manipulation.

These broad categories do not appear to apply to governmental and not-for-profit organizations unless the methods underlying the execution of fraudulent financial reporting are understood. Research by the COSO found the following methods to be the most common ways in which fraudulent financial reporting was executed:

- Overstatement of earnings.
- Fictitious earnings.
- Understatement of expenses.
- Overstatement of assets.
- Understatement of allowances for receivables.
- Overstatement of inventories due to inclusion of obsolete goods.
- Overstatement of property values and creation of fictitious assets.

In this context the findings of the COSO are indeed relevant to governmental and not-for-profit organizations.

**Misappropriation of Assets**

SAS No. 99 addresses the misappropriation of assets only to the extent the effects of such misappropriations cause the financial statements to be materially misstated. Most often the misappropriation of assets is accompanied by false or misleading records or other supporting documents. Such false or misleading documentation is possible because internal controls are either missing or circumvented. Typically these types of misappropriations occur through
• Embezzlement of receipts.
• Stealing assets.
• Causing the entity to pay for goods/services it has not received.

Professional Skepticism

Due professional care has always required auditors to exercise professional skepticism and SAS No. 99 further emphasizes this responsibility. As characterized in SAS No. 99, professional skepticism is an attitude that requires the auditor to

• Have a questioning mind and
• Critically assess audit evidence.

This attitude of professional skepticism is to be present throughout and during all aspects of the audit engagement and exercised at all times by the entire engagement team. This may prove challenging for those auditors with long-term and/or close client relationships.

Preliminary Considerations and Evaluations

The requirements of SAS No. 99 providing for the preliminary consideration and evaluation of fraud risks by the auditor are as follows:

• Consideration of potential fraud risks.
• Assessment of potential fraud risks.
• Identification of fraud risks.
• Evaluation of programs and controls.

Consideration of Potential Fraud Risks

In order to identify fraud risks related to a particular entity, the engagement team must first discuss what specific risks may exist in relation to the audit entity. This requirement of SAS No. 99 is a significant change to previous guidance related to consideration of fraud in a financial statement audit.

The preliminary session should include all members of the audit engagement team and the discussion should include the following:

• Brainstorming session regarding
  – How and where the audit entity’s financial statements may be susceptible to material misstatement due to fraud.
  – How management could perpetrate and conceal fraudulent financial reporting.
  – How assets of the audit entity could be misappropriated.
• An emphasis on the importance of maintaining the proper state of mind throughout the audit engagement related to the potential for material misstatements due to fraud.
Included should be a discussion of external and internal factors affecting the entity and how the auditor anticipates responding to any susceptibility the entity might have with respect to fraud. These discussions should include situations that might

- Create incentives/pressures for management and/or others to commit fraud.
- Provide opportunities for fraud to be perpetrated.
- Indicate a culture/environment enabling management or others to rationalize committing fraud.

• The discussion should include a consideration of the risk of management override of controls.

The nature of these discussions necessitates the full inclusion and participation of all members of the engagement team. Often the most junior members of the engagement team will have best perspective of areas where the audit entity is susceptible to fraud. Therefore, more senior members of the engagement team that are removed from the detailed operational aspects of the audit entity might need to defer to the suggestions of less senior engagement team members.

**Tip:** The atmosphere during the brainstorming session should encourage all present to fully and freely participate in the discussion of fraud risks. In some cases and in certain circumstances, auditors may find it beneficial to include certain client personnel in portions of the brainstorming session. Some firms have conducted two brainstorming sessions – one with firm personnel and a second one with firm and appropriate client personnel.

**Tip:** SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, states that members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity’s financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by SAS No. 99 to discuss the susceptibility of the entity’s financial statements to fraud.

### Assessment of Potential Fraud Risks

Once potential fraud risks have been identified by the engagement team, they should be assessed by appropriate members of the engagement team. Ways in which SAS No. 99 specifies how fraud risks are to be assessed include the following:

• Inquiries of management and others within the audit entity regarding the risks of fraud and how they are addressed.

**Tip:** In making inquires of client personnel regarding potential fraud risks it is necessary for the auditor to carefully consider who to ask, what to ask them, and where to ask them. It is extremely important for the auditor to select not only the proper individuals for fraud related inquiries but to ask them the right questions in an appropriate setting. The auditor should carefully select the timing and location of these inquiries to minimize any stress client personnel might feel and to maximize the information that might be forthcoming. For example, the CFO might be hesitant to fully discuss potential fraud risks if the CEO is included in the same discussion. Likewise, an accounts payable clerk might provide more thoughtful and insightful observations when they are not rushed to input invoices for the weekly check run.
• Performance of analytical procedures as part of the planning process.
  – Provisions of SAS No. 99 require auditors to perform analytical procedures related to revenue for purposes of identifying unusual/unexpected relationships that may indicate material misstatements due to fraudulent financial reporting.

  **Tip**: Often preliminary analytical procedures focus solely on absolute changes in or differences from prior year or budgeted amounts. In certain areas, ratio analysis might provide more useful information in preliminary analyses as well as final substantive procedures.

Calculating and comparing the number of days sales in ending accounts receivable, for example, might be a more effective analytical procedure to detect fraud than comparing the current balance to that of the prior year. Any preliminary analytical procedures should be cross-referenced where appropriate to other audit documentation as additional evidence of substantive procedures.

• Consideration of fraud risk factors.
• Consideration of other information helpful in identifying fraud risks.

**Identification of Fraud Risks¹**

The auditor should consider information gathered with respect to the potential fraud risks (identified in the first stages of the audit planning process) in light of the following conditions:

• Incentives/pressures.
• Opportunities.
• Attitudes/rationalizations.

The existence of all three of these conditions may indicate the risk of material misstatement due to fraud exists. However, it is not necessary that any or all of these conditions be present for the auditor to conclude that identified fraud risks exist. Fraud risks may be identified using other criteria or characteristics, such as

• Entity size.
• Complexity of the entity.
• Ownership attributes of the entity.

A number of governmental and not-for-profit organizations are relatively small in either or both dollar volume or number of employees. This and the lack of ownership attributes in

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¹ It should be noted that SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures.
governmental and not-for-profit organizations may indicate fraud risks for the auditor to consider in planning and conducting the audit engagement.

SAS No. 99 discusses other areas where the potential for material misstatements due to fraud may be present. The additional areas the auditor is required to consider in assessing fraud risk are as follows:

- *Improper revenue recognition* – Material misstatement due to fraud relating to revenue recognition is presumed in the provisions of SAS No. 99.
- *Risk of management override* – Regardless of other identified fraud risks, provisions of SAS No. 99 require the auditor to consider management override as a fraud risk. Specific procedures should be performed with respect to
  - Examining journal entries and other adjustments.
  - Performing retrospective reviews of accounting estimates for biases.
  - Understanding the business rationale for significant unusual transactions.

**Evaluation of Programs and Controls**

Management of an entity is responsible for fraud prevention, detection, and deterrence. As part of the understanding of internal control sufficient to plan the audit, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation. In addition, the auditor should determine if the programs and controls mitigate identified fraud risks or if there are specific control deficiencies that may actually exacerbate fraud risks.

**Tip:** Client personnel who originally designed either all or portions of the internal control systems may be asked to evaluate their effectiveness in preventing, deterring, and detecting fraud. Therefore, it is important for the auditor to ascertain who designed the controls/programs of interest and/or who is responsible for maintaining these systems. In these cases, the auditor should exercise a high degree of professional skepticism as control system designers might not provide a totally objective evaluation of their programs and controls.

**Auditor Response**

SAS No. 99 significantly changed how auditors develop appropriate responses to identified fraud risks. In some cases, the provisions of SAS No. 99 may require the auditor to perform significant additional audit procedures.
Responding to Assessed Risk

Auditors are to respond to the assessment of fraud risks by exercising professional skepticism in gathering and evaluating audit evidence. Applying professional skepticism in response to identified fraud risks might involve

- Designing additional or different audit procedures to obtain more reliable evidence.
- Obtaining additional corroboration of management’s explanations or representations concerning material matters.

The ways in which auditors may respond to risks of material misstatement due to fraud are as follows:

- A response having an overall effect on how the audit is conducted.
- A response to identified risks involving the nature, timing, and extent of planned auditing procedures.
- A response involving performing certain procedures to further address fraud risk due to management override.

In the event an auditor determines it is impractical to design audit procedures that will sufficiently address the identified fraud risks, they may wish to withdraw from the engagement with communication to the appropriate parties.

Evaluating Audit Evidence

Applying the provisions of SAS No. 99, the auditor evaluates audit evidence in the following manner:

- Assess risks of material misstatements due to fraud throughout the audit.
- Evaluate whether analytical procedures performed as substantive tests or in the overall review stage of the audit indicate previously unrecognized risks of material misstatements due to fraud.
- Evaluate risks of material misstatements due to fraud at or near the date of the auditor’s report.
- Respond to misstatements that may be the result of fraud.

Communication and Documentation

When evidence of fraud exists, the auditor is required to bring it to the attention of the appropriate level of management.

Communication is required when there is “evidence that a fraud may exist.” This is not the same as identifying fraud risk factors or observing any of the three fraud conditions delineated in SAS No. 99.

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It should be noted that SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained, requires the auditor to determine overall responses and design and perform further audit procedures to respond to the assessed risks of material misstatement at the financial statement and relevant assertion levels in a financial statement audit.
The levels at which fraud occurs indicate the level of management to which the auditor is required to communicate the potential fraud. However, the auditor and those charged with governance (e.g., the audit committee) should reach an understanding regarding the nature and extent of their communications related to misappropriations perpetrated by lower level employees.

Provisions of SAS No. 99 require communication of potential fraud at and to the following levels of the audit entity:

- Fraud involving senior management (regardless of materiality) – those charged with governance.
- Fraud causing a material misstatement in the financial statements (regardless of the level at which it was perpetrated) – those charged with governance.
- Fraud involving lower level employees – management at least one level above level of fraud.
- Significant deficiencies and material weaknesses relating to internal control – senior management and those charged with governance.

In some cases the auditor may have a responsibility to report evidence of fraud to parties outside the audit entity. Such incidents are typically not part of the auditor’s responsibility and therefore precluded by the ethical and legal obligations of confidentiality. However, in the following instances the auditor may have a responsibility to outside parties:

- To comply with certain legal and regulatory requirements.
- In response to inquiries of a successor auditor under SAS No. 84, Communications between Predecessor and Successor Auditors.
- In response to a subpoena.
- To a funding agency or other specified agency in accordance with requirements for audits of entities receiving governmental financial assistance.

Many governmental and not-for-profit organizations receive significant amounts of governmental financial assistance. Therefore, auditors of these organizations may wish to determine during the planning phase of the engagement whether there is a potential need to communicate to funding agencies regarding any evidence of fraud.

SAS No. 99 requires the auditor to document the following:

- Planning discussions including the preliminary brainstorming session.
- Procedures performed to identify and assess fraud risks.
- Specific fraud risks identified including a description of the auditor’s response to said risks.
- Reasons, if applicable, improper revenue recognition is not an identified fraud risk.
- Results of additional procedures performed to address risk of management override.
- Other conditions and analytical relationships causing the auditor to believe additional auditing procedures or other responses were required.
- Nature of communications regarding fraud made to management, those charged with governance, and others.
Summary

This chapter focuses on how the provisions of SAS No. 99 change the auditor’s consideration of fraud in a financial statement audit. It points out how the requirements and guidance should be integrated into the overall audit process. Also this chapter discusses how auditing is a continuous process of gathering, updating, and analyzing information throughout which the auditor should exercise professional skepticism.

To summarize, SAS No. 99:

- Describes and delineates the characteristics of fraud.
- Stresses the importance of exercising professional skepticism.
- Provides guidance with respect to required communications between the auditor, client, and others regarding fraud.
- Sets forth documentation standards related to the auditor’s consideration of fraud.
- Requires the auditor to
  - Discuss risks of material misstatement due to fraud with the engagement team.
  - Obtain information needed to identify risks of material misstatement due to fraud.
  - Identify risks that may result in material misstatement due to fraud.
  - Assess identified fraud risks and respond to the results of the assessment.
  - Evaluate the audit evidence.
Review Questions and Case Example

1. Why do audits performed under generally accepted auditing standards meet the standard of reasonable assurance rather than absolute assurance with respect to amounts in the financial statements?

2. What are the “sides” of the fraud triangle?

3. How does SAS No. 99 differentiate between material financial statement misstatements due to errors and to fraud?

4. How does SAS No. 99 define fraud?

5. Why might it be difficult for the auditor to detect fraud due to management override of existing internal controls?
6. How does SAS No. 99 characterize professional skepticism?

7. What are the four ways SAS No. 99 specifies as to how fraud risks are to be assessed in the first stages of the audit planning process?

8. In addition to the three fraud conditions identified in SAS No. 99, what two additional areas are identified as potential fraud risks the auditor is required to consider in assessing total fraud risk?

9. According to SAS No. 99, in what three ways does the auditor respond to fraud risk?

10. When does SAS No. 99 require the auditor to communicate fraud and at what level of occurrence and to whom?
Case 2-1 – Aspects of Applying SAS No. 99

Directions and Background

Read the following facts about Able, Best & Co., CPAs and answer the questions in the space provided.

Able, Best & Co. is a medium size regional firm with 35% of its gross revenues coming from audit fees. The firm has developed a reputation in the region as being specialized in audits of small and medium size cities. Approximately half of the firm’s audit fees are from audits of governmental organizations within the region.

Due to the significant amount of governmental audit engagements, the firm has a number of qualified staff meeting the qualifications for audits of governmental organizations. Qualified firm personnel include one partner, three managers, two in-charge accountants, and three staff accountants.

Facts

The City of ABC has been audited for over 50 years by a local CPA firm. The City of ABC is the largest city in the area and for the past five years has experienced a moderate amount of growth in its population and tax base. Three of the five members of the City Council believe the City needs a larger audit firm with more expertise in local government financial matters. All Council members agree a change of audit firms is necessary in order to get a “fresh look” at the City’s operations and financial condition.

Two months prior to the end of the fiscal year, the City Council decides to terminate its relationship with the local CPA firm effectively immediately. An advertisement is placed the next week soliciting proposals from qualified firms to provide audit services for the current year and subsequent two years. Proposals are to include:

- Resumes for individuals to be assigned to the engagement;
- A listing of current local government clients and the type of services provided to them;
- The estimated time to conduct the audit and a time line for completion and receipt of all required reports; and,
- A fee for the audit services.

In order to present a competent and responsive proposal, the partner-in-charge of audit services and the partner in charge of governmental audit services for Able, Best & Co. met with the Director of Finance for the City of ABC and learned the following:

- The City required a great deal of assistance from the former CPA firm in preparing the financial statements and statutory reports for the City.
- The City has two component units – a volunteer fire department (blended presentation) and an art museum (discrete presentation). The Mayor is a member of the volunteer fire department and two of the Council members sit on the board of directors at the art museum. The art museum has the same fiscal year end as the City but is audited by another CPA firm.
- Finance Department staff consists of the Director of Finance, an accounts payable clerk, a cashier, and a utility billing clerk. The Director of Finance has an undergraduate degree in accounting, but is not a CPA. All Finance Department staff have been in their current positions for at least 10 years.

- The audit fee for the prior year engagement was $15,000 and $5,000 remains unpaid at the direction of the City Council. The $5,000 was withheld due to a dispute between the Director of Finance and the CPA firm over several reported significant deficiencies related to potential fraud risks.

- The City of ABC received $1,000,000 from the U.S. Department of Transportation to add a turn lane to Main Street.

Using this information and relying on their experience with other local government audit engagements, Able, Best & Co. submitted a proposal for audit services in the amount of $25,000. They believe the increase in the fee over that of the former CPA firm is justified based on the amount of work to be performed. If the firm is awarded the three-year contract, the City of ABC will be the largest governmental client of Able, Best & Co. and the third largest overall audit client.

Three CPA firms (two regional and one local) submitted proposals and only Able, Best & Co. made a point of visiting the Director of Finance to obtain a better understanding of the City and its needs. The City Council considered the three proposals at its last meeting of the fiscal year. Discussion centered on the fee increase noted in all of the proposals and the qualifications of the personnel to be assigned to the engagement. During the discussion, one of the Council members suggests the fee increase can be justified because larger firms have more staff which makes them better at finding fraud.

After much discussion, the City Council awards a three-year contract for audit services to Able, Best & Co. even though their fee is higher than those of the other two firms. The deciding factor in the selection of Able, Best & Co. was the quality of the personnel to be assigned to the engagement.

**Questions**

1. Based on the facts above, what might concern Able, Best & Co. when applying the requirements of SAS No. 99 in the first year of the contract?

2. What fraud risk factors might exist with respect to the concerns identified in Question 1?
3. What aspects of the fraud triangle should be considered in these circumstances?
Chapter 3

Applying SAS No. 99 in the Governmental and Not-for-Profit Environments

Chapter Objectives
This chapter will identify and analyze how to:

- Understand how the requirements of SAS No. 99 specifically apply to audits of governmental and not-for-profit organizations.

Professional Skepticism in Governmental and Not-for-Profit Engagements
Due professional care related to the consideration of fraud in a financial statement audit is characterized as professional skepticism under the guidance set forth in SAS No. 99. Professional skepticism is an attitude that is to be present throughout and during all aspects of the audit engagement. It requires the entire engagement team to have a questioning mind and to critically assess audit evidence.

Some governmental organizations are required by state statute, local ordinance, or policy to periodically rotate auditors. However, for many governmental organizations, no such mandatory rotation of auditors is required. Some not-for-profit organizations may be required by their own policies or bylaws to periodically rotate auditors. In some cases, not-for-profit organizations representing independent local affiliates of a national organization may be required by the national organization to rotate auditors. However, for many not-for-profit organizations, no such mandatory rotation of auditors is required.

Often, long term and/or close relationships develop between the auditor and governmental or not-for-profit organization due to the following:

- No requirement to rotate auditors exists.
- In some geographic locations, especially rural areas, there may be only one or a limited number of firms meeting the qualifications to audit these organizations.
- For governmental audits, the very nature of personal or business relationships formed as a result of the political process and/or environment.
For not-for-profit audits, members of the audit firm may have friendships with those involved in the board of directors of the not-for-profit organization or otherwise involved with the organization in a volunteer capacity.

For those auditors with long-term and/or close relationships with their governmental and not-for-profit clients, it may prove difficult to adopt the required level of professional skepticism. Even when auditors feel they have assumed the level of professional skepticism required by SAS No. 99, the “appearance” of professional skepticism may not be apparent to those outside the audit firm.

Some audit firms have a limited number of professionals with the requisite training and experience to work on audit engagements of these types of organizations. This may result in them being assigned to the audit of a particular governmental or not-for-profit organization for a number of years in a variety of professional staff capacities.

Long term auditor-client relationships and/or multi-year assignment of professional staff to a particular audit entity may give the auditor a false sense of security with respect to the organization under audit. In these situations (whether or not a long term relationship exists between the auditor and the organization), engagement and/or firm staff may believe client personnel to be honest and to act with integrity. Because it may be difficult for audit staff members to exercise appropriate professional skepticism in these circumstances, the engagement team should constantly strive to put aside past relationships with the organization.

Common Areas of Interest

With respect to the consideration of fraud, audits of governmental and not-for-profit organizations share a number of areas in common with audits of for-profit entities. The common areas of interest to the auditor considering fraud in these organizations are

- Overstatement of earnings/increases in net assets.
- Fictitious revenues.
- Improper revenue recognition.
- Understatement of expenses/expenditures.
- Overstatement of assets.
- Understatement of allowances for receivables.
- Overstatement of inventories due to inclusion of obsolete goods.
- Overstatement of property values and creation of fictitious assets.

The “process” of fraud is normally the same for all types of organizations. Typically, fraud occurs in the following three step process:

- The fraud is committed.
- Perpetrators receive the benefits of the fraud.
- The fraud is concealed.
Auditors do not usually observe fraud as it is committed nor do they often recognize when the perpetrator of fraud realizes its benefits. In most cases, auditors detect fraud when, or after, the perpetrator attempts to conceal the fraudulent act. Therefore audit procedures should be planned and performed accordingly.

**Unique Areas of Concern in Governmental Engagements**

There are a number of areas of concern that are unique to governmental organizations with respect to the consideration of fraud in financial statement audits. Some of these unique areas generally universal to the consideration of fraud in audits of governmental organizations are as follows:

- Fund accounting.
- Interfund transactions, loans, and advances.
- Functional allocation of expenses at the government-wide level.
- Internal accounting controls.
- Repeat significant deficiencies and/or other matters related to internal control.

**Fund Accounting**

Using the fund structure, governmental organizations are able to conceal, misrepresent, or manipulate transactions whether with the intent to defraud or not. Many governmental officials and employees find it easy to rationalize improper fund transactions and/or accounting for a number of reasons including the following:

- Maintains current tax levels.
- Maintains current user fee levels.
- The belief that no one understands fund accounting.
- The belief that all financial resources should be available for all operations of the governmental organization regardless of external restrictions.

**Interfund Transactions**

Interfund transactions can be used to conceal a number of irregularities and may result in fraudulent financial reporting if not detected. Examples of potentially fraudulent transactions include offsetting operating losses in business type activities, concealing budget shortfalls, infusing working capital to meet bond covenant ratios, and a number of other transactions. Provisions of GASB No. 34, as amended, require disclosure of interfund transactions by balances and purpose.

**Functional Allocation of Expenses**

GASB No. 34 requires the reporting of expenses at the government wide level by functional classification in the statement of activities. In the statement of activities, functional expenses are
offset by specifically identifiable grants (operating and capital) and charges for services. Some governmental agencies may misstate functional amounts to circumvent legal requirements or to comply with grant provisions or bond covenants.

For example, some states may restrict the amount of building permit revenues to the costs of providing protective inspection services and the related administrative costs. In these states, excess building permit revenues must be returned to the community or the permit holder(s). This might be a concern for a particular local governmental organization if they are experiencing a sustained high level of growth and/or operate very efficiently. In these cases, it is possible building permit fees could exceed the cost of providing protective inspection services.

**Internal Accounting Controls**

As in audits of for profit entities, internal accounting controls are also of concern in audits of governmental organizations. Somewhat unique to the internal control structure of many governmental organizations is the lack of staff or the lack of qualified staff in administrative and/or accounting and finance functions. This results usually in improper segregation of duties, a high level of error in recording transactions, and missing or ineffective control systems.

Another unique aspect of governmental organizations with respect to the consideration of fraud is that of employee compensation and longevity. Typically, many employee classes in the public sector are paid less than their counterparts in the private sector. Ironically, public sector employees tend to have greater time in position and increased overall longevity. These factors considered with limited administrative and/or accounting and finance functions represent textbook conditions for fraud.

**Repeat Significant Deficiencies and Other Matters Related to Internal Control**

Many of the internal control weaknesses discussed above often result in significant deficiencies. In some governmental organizations there is a strong mindset toward providing services to stakeholders at the expense of administrative support functions. As a result, significant deficiencies may continue to exist for a number of years. This may also hold true for other matters related to internal control repeated from year to year.

From an audit planning perspective, the auditor of a governmental organization may need to consider these situations as fraud risk factors. The reasons for not implementing other matters related to internal control recommendations or not correcting significant deficiencies may indicate an attitude of rationalization throughout the entire governmental organization. Additionally, the continued existence of missing or ineffective internal controls might create incentives and/or opportunities for fraud to occur.

**Other Unique Areas of Concern**

The following areas are also of concern in audits of governmental organizations

- *Availability and training of the firm’s governmental audit staff.*
- *Exercise of professional skepticism.*
Applying SAS No. 99 in the Governmental and Not-for-Profit Environments

Government auditing standards require audit engagement team members to have a certain number of continuing education hours in governmental accounting and auditing topics. Many states mirror these requirements or have adopted their own continuing education requirements for auditors of governmental organizations. As such, having adequate professional staff for governmental audit engagements may be a challenge for some audit firms and especially small audit firms.

This is a great concern when considered in light of the SAS No. 99 requirement related to the exercise of professional skepticism. It is often difficult for auditors to exercise the proper level of professional skepticism throughout an audit engagement when they have been on the engagement team for a number of years.

Unique Areas of Concern in Not-for-Profit Engagements

There are a number of areas of concern that are unique to not-for-profit organizations with respect to the consideration of fraud in financial statement audits. Some of these unique areas generally universal to the consideration of fraud in audits of not-for-profit organizations are as follows:

- Contributions received from resource providers.
- Goods or services not provided at a profit.
- Lack of ownership interests.
- Related party transactions.
- Functional allocation of expenses.
- Internal accounting controls.
- Repeat significant deficiencies and/or other matters related to internal control.
- Split-interest agreements.

Significant Contributions

Not-for-profit organizations often rely on contributions from individuals and businesses to fund the services they provide as part of their mission. Such contributions are often significant to the total resources available to the not-for-profit organization. Those providing resources to a not-for-profit organization make their contributions with no expectation of financial or other remuneration.

In addition, contributions or grant monies received by a not-for-profit organization may be subject to donor restrictions imposing time or use restrictions either on a temporary or permanent basis. Such contributions are required to be classified as restricted until the restriction has been lifted or satisfied.
Valuable and sometimes **significant services are contributed** on behalf of, or for the benefit of, the not-for-profit organization or the clients it serves. Depending on the type of contributed services, they are required to be either recorded in the financial statements or disclosed in the notes to the financial statements.

**Lack of a Profit Motive**

Not-for-profit organizations are organized for and **operated to achieve a particular mission rather than to make a profit** from their operations. It is this dedication to mission that drives the operations of most not-for-profit organizations. In furtherance of their missions, not-for-profit organizations typically provide goods and/or services to the community in many cases, without regard to how much is paid by those receiving the goods or services. Even in cases where the not-for-profit organization intends to recover its costs with fees/charges, not all costs are included in determining the fee structure.

**Ownership Interests**

Not-for-profit organizations do not have stockholders; therefore, the **equity in the not-for-profit organization is represented by its net assets**. Because there are no “owners” in a not-for-profit organization, no “owners” exist to protect the net assets of the not-for-profit organization.

**Related Party Transactions**

In a number of not-for-profit organizations, individuals are selected to serve on the board of directors based on the financial or economic resources available to them in other capacities. At times, management of the not-for-profit organization draws on these connections in securing financial, human, or capital resources. These types of transactions may represent below market transactions or may not be arm’s-length in nature. In any event, such transactions may require disclosure in the financial statements as related party transactions.

Local independent not-for-profit organizations may be affiliated with regional, national, or international not-for-profit organizations. Transactions with and among these entities may require disclosure in the financial statements as related party transactions.

**Functional Allocation of Expenses**

FASB No. 117 requires not-for-profit voluntary health and welfare organizations to report expenses by their functional and natural classifications in a matrix format. Other not-for-profit organizations are required by FASB No. 117 to report expenses by functional classifications and are encouraged to provide information about their natural expense classification. Some not-for-profit organizations may misstate functional amounts to circumvent Internal Revenue Service requirements or to comply with grant provisions or debt covenants.

**Internal Accounting Controls**

As in audits of for profit entities, internal accounting controls are also of concern in audits of not-for-profit organizations. Somewhat unique to the internal control structure of many not-for-profit organizations is the lack of staff or the lack of qualified staff in administrative and/or accounting
and finance functions. This results usually in improper segregation of duties, a high level of error in recording transactions, and missing or ineffective control systems.

Another unique aspect of not-for-profit organizations with respect to the consideration of fraud is that of employee compensation and turnover. Typically, employees of not-for-profit organizations are paid less than their counterparts in the private sector. This is especially true for administrative or overhead type positions. As a result, employee turnover in these types of positions may be high when compared to for profit organizations. These factors considered with limited administrative and/or accounting and finance functions represent textbook conditions for fraud.

**Repeat Significant Deficiencies and Other Matters Related to Internal Control**

Many of the internal control weaknesses discussed above often result in significant deficiencies. In most not-for-profit organizations there is a strong mindset toward providing services to achieve the mission of the organization at the expense of administrative support functions. As a result, significant deficiencies may continue to exist for a number of years. This may also hold true for other matters related to internal control repeated from year to year.

From an audit planning perspective, the auditor of a not-for-profit organization may need to consider these situations as fraud risk factors. The reasons for not implementing other matters related to internal control recommendations or not correcting significant deficiencies may indicate an attitude of rationalization throughout the entire not-for-profit organization. Additionally, the continued existence of missing or ineffective internal controls might create incentives and/or opportunities for fraud to occur.

**Split-Interest Agreements**

Donors may enter into trust agreements or other arrangements wherein a not-for-profit organization may receive benefits that are shared with other organizations. Terms of these arrangements may be revocable by the donor in certain situations. These agreements may exist for either a finite number of years, in perpetuity, or for the remaining life of a specific individual.

Split-interest agreements present revenue recognition issues for the not-for-profit organization and the auditor. Such agreements are usually of the following types:

- Charitable lead trusts.
- Perpetual trusts held by third parties.
- Charitable remainder trusts.
- Charitable gift annuities.
- Pooled (life) income funds.

**Other Unique Areas of Concern**

Earlier, we mentioned that the following two items are additional concerns to the auditor in audits of governmental organizations:
• Availability and training of the firm’s audit staff.
• Exercise of professional skepticism.

Obviously, the same two items are concerns to the auditor of not-for-profit organizations.

Identification of Fraud Risks in Governmental and Not-for-Profit Engagements

The Fraud Triangle

As mentioned in the previous chapter, the conditions under which fraud generally occurs delineated in SAS No. 99 as the “fraud triangle” are incentive or pressure, opportunity, and rationalization or attitude.

Incentive or Pressure

Employees of governmental organizations are under constant pressure to provide more and/or higher quality services with fewer resources. When the economy is in decline, there is added pressure on governmental organizations to maintain current tax rates and user charges. This places pressure on the management of governmental organizations to meet or improve upon budgeted amounts. An incentive to overstate revenues or to understate expenses/expenditures may be created by this pressure.

Similarly, when the economy is in decline, there is often added pressure on not-for-profit organizations to provide additional services and/or the same services to a larger population. This may pressure the management of not-for-profit organizations to meet or exceed service level targets for both outputs and outcomes.

In an effort to obtain additional grant funds or contributions from resource providers, not-for-profit organizations may have an incentive to overstate revenues and/or results. Additionally, not-for-profit organizations may have an incentive to understate expenses in an effort to appear more efficient and/or effective to potential grantors or donors. For some higher levels of management, annual compensation may be based in part on the financial, service, or overall performance of the not-for-profit organization. This may create an incentive for fraud among those employees.

Opportunity

As stated previously, the lack of personnel or the lack of sufficiently qualified personnel is prevalent in administrative and/or accounting and finance functions in governmental and not-for-profit organizations. The resulting lack of, or ineffective, internal controls creates opportunities for fraud.

Governmental organizations often have a number of locations taking cash in payment of services such as recreation centers, police departments, libraries, etc. Lacking or ineffective controls create opportunities for fraud in these areas also. It is highly likely the amounts of many of these
revenues are not material to the financial statements of the governmental organization taken as a whole. However, one of the objectives of financial reporting for governmental organizations is public accountability. Situations such as these, while not material to the financial statements, are material to public accountability.

Likewise, not-for-profit organizations may be involved in a number of activities wherein large amounts of cash are collected. Additionally, cash may be collected in a number of locations and/or by persons lacking knowledge of existing internal controls. Lacking or ineffective controls create opportunities for fraud in these areas also. In some cases the amounts of these revenues may not be material to the financial statements of the not-for-profit organization taken as a whole. However, the objectives of financial reporting for not-for-profit organizations necessitate consideration of these revenues by the auditor.

Rationalization or Attitude
Employees of governmental and not-for-profit organizations are often paid less than their counterparts in the private sector. This, coupled with the pressure to continue to provide a high level of service, may create an environment in which employees are able to rationalize perpetrating fraud. Some employees of governmental and not-for-profit organizations may rationalize the misappropriation of organizational assets as compensation for their low salary levels. Again, such situations may not result in material misstatements of financial amounts. They are, however, violations of the public trust and serve as a measure of accountability.

Preliminary Considerations of Fraud
In order to identify the risk of material misstatements due to fraud, SAS No. 99 requires the auditor to provide for the preliminary consideration and evaluation of fraud risks through

- Consideration of potential fraud risks.
- Assessment of potential fraud risks.
- Identification of fraud risks.
- Evaluation of programs and controls.

Issues Related to the Preliminary Considerations of Fraud
It may be difficult for the auditor to determine who within the organization should respond to the inquiries related to fraud. After appropriate management personnel and others have been identified, the auditor is then challenged to ascertain whether truthful responses will be given to their inquiries. For some individuals, it is difficult for them to think of their employees or coworkers as dishonest or willing to commit fraud. This can be especially true in government and not-for-profit organizations where management may feel everyone is as committed as they are to the mission of serving the public.

When making client inquiries as to fraud, auditors might need to look at employees of the organization not previously considered appropriate for such inquiries. It is often at lower levels of an organization that an auditor might find employees willing to honestly discuss fraud and potential fraud areas within their organizations. Auditors in charge of the engagement should
consider who on the engagement team might be more effective at interviewing client staff as to fraud. For example, some older employees might be more forthcoming with a seasoned engagement team member.

In small and medium organizations, especially, there may be few, if any, management employees with sufficient knowledge to respond to the auditor’s inquiries. The auditor may find it necessary to identify who should respond and then educate them regarding certain aspects of fraud. This may be extremely challenging for the auditor depending on how wide the expectation gap might be.

Another challenge for the auditor of governmental and not-for-profit organizations relates to preliminary analytical procedures. Many governments do not record transactions during the year on a GAAP basis. Many not-for-profit organizations do not record transactions in the proper net asset class except at year end. For preliminary analytical procedures, these situations might create “unexpected” relationships for the auditor. In some cases, interim information might be so incomplete as to make preliminary analytical procedures highly ineffective.

**Additional Issues Related to the Preliminary Considerations of Fraud**

Historically, CPAs have been very good at identifying the presence of fraud risk factors but not as good at designing effective audit procedures to respond to the fraud risk factors they identified. To design effective audit procedures to respond to identified fraud risk factors, the CPA must adequately assess, or synthesize, the identified fraud risks. The process of assessment, or synthesis, is the link between identifying fraud risks and responding to them.

Identified fraud risks should be assessed, that is, synthesized, in order to determine

- Where the audit entity is most vulnerable to material misstatement due to fraud.
- The types of fraud most likely to occur within the entity.
- How material misstatements are likely to be concealed.

To effectively assess, or synthesize, fraud risk, the auditor should apply the “fraud triangle” to the audit entity. This process is done in the preliminary stages of the audit planning process but also continues throughout the entire audit engagement. Once identified, the auditor should determine whether the identified risks are related to either

- Specific accounts or transactions or
- The financial statements as a whole.

**Controls**

Governmental and not-for-profit organizations may not have staff with the requisite expertise to design effective fraud prevention, detection, and deterrence programs. Additionally, there may be too few administrative and/or accounting and finance personnel to design, implement, administer, and monitor such programs and controls.
Responding to Assessed Risk in Governmental and Not-for-Profit Engagements

Auditors are to respond to the assessment of fraud risks in these organizations by exercising professional skepticism in gathering and evaluating audit evidence. Applying professional skepticism in response to fraud risks identified in audits of governmental and not-for-profit organizations might involve

- Designing additional or different audit procedures to obtain more reliable evidence.
- Obtaining additional corroboration of management’s explanations or representations concerning material matters.

The ways in which auditors may respond to risks of material misstatement due to fraud are as follows:

- A response having an overall effect on how the audit is conducted.
- A response to identified risks involving the nature, timing, and extent of planned auditing procedures.
- A response involving performing certain procedures to further address fraud risk due to management override.

In the event an auditor determines it is impractical to design audit procedures that will sufficiently address the identified fraud risks, they may wish to withdraw from the engagement.

Overall Responses

The overall response to judgments regarding the risk of material misstatements due to fraud affects audits of governmental and not-for-profit organizations in the following manner.

- Assignment of personnel and supervision – Because of limited qualified governmental and not-for-profit auditors, this could be difficult for the auditor.

- Choice of accounting principles – In light of the requirements of GASB No. 34, the auditor will need to review a number of accounting choices made by their governmental organization clients. Likewise, with the requirements of FASB Statements No. 116 and No. 117, the auditor will need to review a number of accounting choices made by their not-for-profit organization clients. Other FASB pronouncements also require the not-for-profit organization to make choices regarding the accounting for certain types of transactions.

- Predictability of auditing procedures – This is especially difficult when a long term client relationship exists and it is exacerbated with the tendency toward longevity in employees of governmental organizations. It may also be exacerbated if there are long-term employees within the not-for-profit organization, especially in the accounting or finance areas.
Response to Address Specific Accounts or Classes of Transactions

Typically, responses to address the risk of material misstatements due to fraud in specific accounts or classes of transactions relate to audit procedure modification in the following areas:

- Nature.
- Timing.
- Extent.

Contracts between the auditor and the organization may be fixed as to fee and/or restrictive as to completion deadlines. Some audits of not-for-profit organizations may be done for extremely low fee amounts as many not-for-profit organizations have limited funds for administrative and/or overhead type expenses. In the absence of such contractual constraints, statutory or grantor requirements may necessitate an absolute date for reports to be submitted/completed. The auditor has to balance these restrictions with professional standards to determine whether a scope limitation may exist.

SAS No. 99 provides additional guidance related to other specific areas where the risk of material misstatements due to fraud might exist. With respect to audits of governmental and not-for-profit organizations these additional areas are

- Revenue recognition.
- Accounting estimates.

**Risks Related to Revenue Recognition and Accounting Estimates – Governments**

Because of the large number of grants or other intergovernmental revenues common to most governmental organizations, revenue recognition may be of particular concern to the auditor with respect to the consideration of fraud. The concern here is more with misstatements due to fraudulent financial reporting than misappropriation of assets. Generally accepted accounting principles related to recording exchange and non-exchange transactions contribute to the issue of proper revenue recognition in governmental organizations.

However, it is possible that in some governments revenue recognition may not be a fraud risk area from the perspective of misappropriation of assets. In some localities, all material revenues are received via electronic funds transfers or checks on a periodic basis from another governmental agency. This holds true for municipal property taxes in a number of states where the county acts as the tax assessor and collector for all taxing authorities within its jurisdiction. For many governments, revenues received in cash or at offsite locations with few internal controls are often immaterial to the financial statements taken as a whole.

Accounting estimates made by governmental organizations are also of particular concern to the auditor with respect to the consideration of fraud. From a fraudulent financial reporting perspective, the accounting estimates made by governmental organizations of concern to auditors relate to
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- Allowances for material uncollectible receivables such as taxes, special assessments, and customer receivables.
- Estimated useful lives of capital assets.
- Assessed condition of infrastructure assets if using the modified approach.
- Actuarial valuations of pension and other post-employment benefit obligations.
- Estimates of accrued compensated absences.
- Estimated contingent liabilities for litigation, claims, and assessments.
- Functional allocations of direct and indirect costs.

Inventories are also identified in SAS No. 99 as an area warranting additional attention regarding the consideration of fraud. However, in most governmental organizations, inventories are not material to the financial statements taken as a whole. In the event a governmental organization has material inventories and/or they are considered a fraud risk area, the auditor should consult SAS No. 99 for guidance in this area.

Risks Related to Revenue Recognition and Accounting Estimates – Not-for-Profits

With respect to the consideration of fraud, revenue recognition may be of particular concern to the auditor of not-for-profit organizations. The concern here deals with misstatements due to both fraudulent financial reporting and misappropriation of assets.

Specifically, the auditor of not-for-profit organizations should consider revenue recognition issues related to fraudulent financial reporting in the following areas:

- Contributions.
- Membership dues.
- Fund raising.
- Split-interest agreements.
- Grants.
- Healthcare receivables.

As fraud risk associated with revenue recognition in a not-for-profit organization relates to the misappropriation of assets, the auditor should consider the following areas:

- Cash receipts related to
- Contributions.
- Fees for services.
- Dues.

Accounting estimates made by not-for-profit organizations are also of particular concern to the auditor with respect to the consideration of fraud. From a fraudulent financial reporting
perspective, the accounting estimates made by not-for-profit organizations of concern to auditors relate to

- Allowances for material uncollectible receivables such as pledges, special assessments, dues, and customer receivables.
- Split-interest agreements.
- Estimated useful lives of capital assets.
- Estimates of accrued compensated absences.
- Estimated contingent liabilities for litigation, claims, and assessments.
- Allocation of joint costs.
- Functional allocations of expenses.

Inventories are also identified in SAS No. 99 as an area warranting additional attention regarding the consideration of fraud. However, in many not-for-profit organizations, inventories do not exist or are not material to the financial statements taken as a whole. In the event a not-for-profit organization has material inventories and/or they are considered a fraud risk area, the auditor should consult SAS No. 99 for guidance in this area.

**Assessing Management Override**

Most business of governmental organizations is conducted in full view of the government. Therefore, it may appear that consideration of management override with respect to fraud requires little attention in audits of governmental organizations. However, because of the ease with which management may be able to access data and systems and the reluctance of employees to discuss management abuses of such, it is an area of concern for the auditor.

Many not-for-profit organizations in the United States are small to medium sized organizations and often are considered “closely held” due to limited turnover with the board of directors. As such, management may be able to access data and systems with relative ease. Regardless of the size of the not-for-profit organization, employees may be reluctant to discuss management abuses. For these reasons, management override is an area of concern for the auditor.

To assist the auditor in evaluating the risk of management override of controls, SAS No. 99 delineates required procedures for the auditor. Specific procedures should be performed with respect to

- Examining journal entries and other adjustments.
- Performing retrospective reviews of accounting estimates for biases.
- Understanding the business rationale for significant unusual transactions.

**Journal Entries**

With respect to journal entries made by governmental and not-for-profit organizations, the auditor will be required to understand the financial reporting process. This includes determining
what reports are given to decision makers, the frequency of the reports, and how they are prepared. For example, are board members given quarterly reports prepared in a spreadsheet program; and, if so are amounts the same as those generated by the entity’s financial management system? Is multi-year financial data in periodic operating reports adjusted for inflation or changes in CPI?

Auditors should also review the procedures related to journal entries made by the organization. In some organizations, outdated financial management systems often necessitate manual entry of summary transaction data into a general ledger system. Inquiries should include who is authorized to prepare and post journal entries, what approvals are required and by whom, and do adequate explanations accompany the adjustments? Because of the missing or ineffective internal control systems, the auditor may find few controls related to journal entries made by governmental and not-for-profit organizations.

**Accounting Estimates**

Fraudulent financial reporting is often the result of intentional misstatements of *accounting estimates* by management or others.

**CONCERNS RELATED TO GOVERNMENTAL ORGANIZATIONS**

The auditor of the governmental organization is primarily concerned with estimates related to

- Allowances for material uncollectible receivables such as taxes, special assessments, and customer receivables.
- Estimated useful lives of capital assets.
- Assessed condition of infrastructure assets if using the modified approach.
- Actuarial valuations of pension and other post-employment benefit obligations.
- Estimates of accrued compensated absences.
- Estimated contingent liabilities for litigation, claims, and assessments.
- Functional allocations of direct and indirect costs.

Additionally, auditors should be concerned with how taxable property values are calculated, if applicable. Estimates of budgeted revenues should also be reviewed for potential manipulation as well as how they compare to actual results. It is not uncommon for governmental organizations to be overly optimistic in their revenue estimates or less than generous with expenditure allocations. In these cases, the auditor is primarily concerned with public accountability with respect to

- Balanced budget requirements.
- Ability to continue to finance current services.
- Meeting bond and other debt obligations when due.
CONCERNS RELATED TO NOT-FOR-PROFIT ORGANIZATIONS

The auditor of the not-for-profit organization is primarily concerned with estimates related to

- Allowances for material uncollectible receivables such as pledges, special assessments, dues, and customer receivables.
- Split-interest agreements.
- Estimated useful lives of capital assets.
- Estimates of accrued compensated absences.
- Estimated contingent liabilities for litigation, claims, and assessments.
- Allocation of joint costs.
- Functional allocations of expenses.

As in governmental organizations, it is not uncommon for not-for-profit organizations to be overly optimistic in their revenue estimates or less than generous with expense allocations. However, the legal level of budgetary accountability present in governmental organizations does not exist in not-for-profit organizations. It is not uncommon for not-for-profit organizations to “balance” projected expenses with unrealistic estimates of grant and contribution revenues. The auditor should ascertain the budgetary philosophy of the not-for-profit organization early in the planning stage of the audit.

Business Rationale for Significant Unusual Transactions

Auditors should understand the business rationale underlying significant transactions that are unusual or outside the normal course of business. Because of the political nature of governmental organizations, the auditor might wish to focus on significant unusual transactions. Because of the potential for related party transactions with usually well-meaning board members or with related regional or national affiliates, the auditor of a not-for-profit might wish to focus on significant unusual transactions. The lack of expertise or professional staff in small or medium organizations might unintentionally lead them into significant unusual transactions with potentially negative results.

WITH RESPECT TO AUDITS OF GOVERNMENTAL ORGANIZATIONS

With respect to audits of governmental organizations, possible significant transactions and related auditor questions might include

- *Economic development incentives* – Who ultimately benefits?Were multi-year projections used in the decision process? Were multi-year projections discounted to present value? Were discount rates reasonable? Were grant funds involved? Was the transaction predicated on performance objectives? Was the transaction arm’s-length?

- *Onerous provisions in union contracts* – What negative impacts will be felt in other areas? Will this lead to other unions having the same expectations? Why were the concessions necessary?
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- **Real estate purchases or sales** – Were permanent assets sold and, if so, why? What is the intended use for the proceeds of the sale? What is the intended use of the real estate purchased? Are environmental liabilities assumed/transfered? And, was the real estate sold purchased in whole or in part with grant funds? Was the transaction arm’s-length?

- **Land swaps** – What was the use of the land given up? What is the intended use of the land received? Are environmental liabilities assumed/transfered? And, was the real estate sold purchased in whole or in part with grant funds? Was the transaction arm’s-length?

- **Granting of easements** – What was the business purpose? Was it an exchange transaction and, if not, why? Was the transaction arm’s-length?

- **Public/private partnerships** – Who ultimately benefits? Were multi-year projections used in the decision process? Were multi-year projections discounted to present value? Were discount rates reasonable? Was the transaction predicated on performance objectives? And, was the transaction arm’s-length?

- **Privatizing of governmental services** – Who ultimately benefits? Were multi-year projections used in the decision process? Were multi-year projections discounted to present value? Were discount rates reasonable? Were government owned capital assets transferred to the new service provider and, if so, were any purchased with grant funds? Was the transaction predicated on performance objectives? Will service levels improve or remain unchanged? Does the transaction make business sense? Was the transaction arm’s-length?

- **Early extinguishment of debt** – Was an economic benefit received? What benefit was received if no economic benefit was received? Was the transaction arm’s-length?

**WITH RESPECT TO AUDITS OF NOT-FOR-PROFIT ORGANIZATIONS**

With respect to audits of not-for-profit organizations, possible significant transactions and related auditor questions might include

- **Short or long-term debt** – What was the purpose of the debt? Was the transaction made through the financial institution of a related party and, if so, was it arm’s-length? What collateral or security interest was required to support the transaction?

- **Real estate purchases or sales** – Were permanent assets sold and if so, why? What is the intended use for the proceeds of the sale? What is the intended use of the real estate purchased? Are environmental liabilities assumed/transfered? Was the real estate sold purchased in whole or in part with grant funds? Was the real estate sold donated to the organization and, if so, do donor restrictions related to sale exist? Was the transaction arm’s-length?

- **Public/private partnerships** – Who ultimately benefits? Were multi-year projections used in the decision process? Were multi-year projections discounted to present value? Were discount rates reasonable? Was the transaction predicated on performance objectives? Can the organization “opt out” with adequate notice? Was the transaction arm’s-length?
• Early extinguishment of debt – Was an economic benefit received? What benefit was received if no economic benefit was received? Was the transaction arm’s-length?

Evaluating Audit Evidence in Governmental and Not-for-Profit Engagements

As mentioned previously, the auditor typically detects fraud during the “concealment” step in the three step fraud process. The concealment or lack of concealment, of fraudulent transactions most often is reflected by

• Discrepancies in the accounting records – Lack of supporting documentation.
• Conflicting or missing evidential matter – Missing documentation or inconsistent documentation.
• Problematic or unusual relationships between the auditor and the client – Unusual delays in providing requested information.

The auditor should document the observance of any or all of the situations above. However, the existence of these circumstances may not necessarily indicate the concealment, or lack of concealment, of fraudulent transactions. This would be especially true in small or medium organizations where administrative and/or accounting and finance staff is limited in number, experience, and/or expertise.

Audit procedures should exist to determine if any observations of these circumstances indicate the concealment, or lack of concealment, of fraudulent transactions. Effective methods by which to evaluate if any such noted situations might indicate material misstatements due to fraud include

• Analytical procedures conducted as substantive procedures as part of the overall review stage of the audit.
• Brainstorming sessions with all members of the audit engagement team at or near the end of the engagement to discuss the magnitude and collective significance of any such observations.

Communication and Documentation in Governmental and Not-for-Profit Engagements

SAS No. 99 requires documentation of a number of audit procedures as well as consideration of audit planning issues and fraud risk identification and assessment. The nature of auditor communications with the audit entity regarding fraud are required to be documented under the guidance in SAS No. 99. This includes auditor communications with management, those charged with governance, and others.

In some organizations, it may be difficult for the auditor to differentiate between senior management and non senior management employees. The auditor may also find it difficult to
discern the appropriate level of management to whom fraud involving lower level employees is to be communicated. As part of the audit planning process, the engagement team should

- Obtain a detailed organizational chart.
- Determine the various levels within departmental and organizational chains of command.
- Obtain management’s written representation as to the appropriateness of the identified chains of command.
- Determine the levels at which those charged with governance wish to be informed of the potential existence of fraud.

**Communication with Third Parties**

In some cases the auditor may have a responsibility to report evidence of fraud to parties outside the audit entity. Such incidents are typically not part of the auditor’s responsibility and therefore precluded by the ethical and legal obligations of confidentiality. However, in the following instances the auditor may have a responsibility to outside parties:

- To comply with certain legal and regulatory requirements.
- In response to inquiries of a successor auditor under SAS No. 84, *Communications Between Predecessor and Successor Auditors*.
- In response to a subpoena.
- To a funding agency or other specified agency in accordance with requirements for audits of entities receiving governmental financial assistance.

Many state and local governmental organizations receive significant amounts of financial assistance from the federal government. At the local government level, significant intergovernmental revenues may also be received from the state. During the planning phase of the engagement, the auditor of these organizations should determine whether there is a need to communicate to these agencies should any evidence of fraud be found to exist.

Many not-for-profit organizations receive significant amounts of financial assistance from the federal government either directly or indirectly. Additionally, not-for-profit organizations may receive funds from state and/or local governmental organizations. During the planning phase of the engagement, the auditor of the not-for-profit organization should determine whether there is a need to communicate to these agencies should any evidence of fraud be found to exist.

**Special Concerns in Audits of Governmental Organizations**

In states where public records laws exist, the auditor should seriously consider the form of communication to be used to convey the potential existence of fraud to the governmental organization. SAS No. 99 requires communication, to some level of the audit entity, whenever the auditor has determined there is evidence that a fraud may exist.

For audits of governmental organizations, the *use of the word “may” with respect to the existence of fraud* is critical when considering the form of auditor communication. The auditor
may wish to communicate with the governmental organization in person rather than in writing. In this manner, no public record is created that could later be used in a controversial manner, out of context, or by those not familiar with the entire situation.

With respect to in person meetings, auditors should be aware of legal definitions and requirements related to “public meetings” in the particular jurisdiction of the governmental organization under audit. In the event the auditor has determined it necessary to communicate to parties outside the governmental organization under audit, the legal requirements, if any, related to public meetings of the outside third party should also be ascertained by the auditor. Additionally, in almost all states, the requirements of the Americans with Disabilities Act are to be followed in the noticing and conduct of public meetings.

In some states, the meeting of two or more elected or appointed officials for the purposes of discussing business of the governmental organization constitutes a “public meeting.” Most states require that a notice of, and an agenda for, a public meeting be posted at least 24 or more hours in advance of the meeting. Additionally, some states require that a written record (i.e., minutes) of the proceedings be made and available for public inspection within a certain number days after the meeting.

As such, a meeting to communicate evidence that a fraud may exist to the audit committee of the governmental organization (whether it is the governing body or a volunteer board appointed by the governing body) may constitute a public meeting. The simple act of the auditor to meet two members of the audit committee for lunch to discuss potential fraud may also constitute a public meeting in some states.

Some governmental organizations make a practice of tape recording management staff meetings in lieu of, or as support for, written minutes. Auditors should determine if this is the case before scheduling meetings with management when required under SAS No. 99 to discuss potential fraud.

The issues related to “government in the sunshine,” notice and documentation of public meetings, and what constitutes a public meeting vary from state to state. Audit evidence that a fraud may exist is sensitive information subject to misinterpretation by others if taken out of context or otherwise misunderstood. Therefore, the auditor should exercise informed professional judgment in determining the venue and/or format for communicating evidence that a fraud may exist to appropriate levels of a governmental organization.

**Special Concerns in Audits of Not-for-Profit Organizations**

SAS No. 99 requires communication, to some level of the audit entity, whenever the auditor has determined there is evidence that a fraud may exist. Use of the word “may” with respect to the existence of fraud is critical when considering the form of auditor communication.

Often, management of a not-for-profit may wish to keep the issue of potential fraud as confidential as possible given the circumstances. This attitude of not-for-profit organizations related to keeping the potential existence of fraud confidential often results from
• Faith based attitudes regarding potential fraud (in religious or religious-based not-for-profit organizations).

• General feeling that all people are “good” and not capable of intentionally causing harm to others.

• Fear of alienating current and future donors.

• Belief that others will see the organization as being easily duped.

• Suspected employees may be long-term employees.

• Management feels “guilty” for allowing an environment conducive to fraud to exist.

• Amounts are considered small or the perpetrator was “justified” in misappropriating organizational assets.

The auditor may wish to communicate with the not-for-profit organization in person rather than in writing. In this manner, no written record is created that could later be used in a controversial manner, out of context, or by those not familiar with the entire situation.

Summary

This chapter focused on applying the provisions of SAS No. 99 to audits of the financial statements of governmental and not-for-profit organizations. It pointed out areas of concern for the auditor that are similar to financial statement audits of both governmental and not-for-profit organizations and for profit organizations. Also, this chapter discussed areas of concern for the auditor that are unique to audits of the financial statements of governmental and not-for-profit organizations.

Specific concerns relating to management override were also an area of focus in this chapter. Particular attention was given to those areas unique to governmental and not-for-profit organizations where the auditor is required under SAS No. 99 to assess the business rationale for significant or unusual transactions. Finally, this chapter also brought attention to the issues associated with “communicating” and “documenting” fraud.
Review Questions and Case Examples

1. How is professional skepticism affected when long term or close relationships exist between the auditor and the governmental or not-for-profit organization?

2. What are the three steps in the fraud process?

3. What are the unique areas of concern to the auditor of not-for-profit organizations with respect to the consideration of fraud and why?

4. How does fraud risk related to incentives and/or pressure impact the auditor’s consideration of fraud in the audit of a governmental organization?

5. How does fraud risk related to opportunity impact the auditor’s consideration of fraud in the audit of a governmental organization?
6. What challenges face the auditor of not-for-profit organizations with respect to the overall response to judgments regarding fraud?

7. Other than being required by SAS No. 99, why is revenue recognition of concern in an audit of a governmental organization?

8. List examples of accounting estimates of concern in the audit of a not-for-profit organization.

9. List examples of possible unusual transactions requiring additional procedures under SAS No. 99 and why they might be considered unusual in the audit of a governmental organization.

10. What are potential reasons underlying the decision of a not-for-profit organization to keep the potential existence of fraud confidential?
Case 3-1 – Responding to Management Override as a Fraud Risk Factor

Directions and Background
Read the following facts about the City of XYZ and answer the questions below in the space provided.

You are a medium-sized general-purpose firm with 15% of gross revenues coming from audit fees. Firm personnel meeting the qualifications for audits of governmental organizations include one partner, one in-charge accountant, and one staff accountant.

Only one of your current audit clients is a governmental organization and this is the first year your firm has had the audit engagement for the City of XYZ. The contract for the City of XYZ is a three year contract and includes the financial statement audit only as a Yellow Book audit is not required.

Facts
The brainstorming session with all engagement staff during the preliminary audit planning stage reveals the following information:

- The City is a Manager/Council form of government and the current city manager has been in her current position for three years. Prior to that she served as the City’s Human Resources Director for five years. Her employment contract is renewed annually at the discretion of the City Council.

- The terms of the City Manager’s contract state she may be discharged at any time without cause but will receive six-months of salary as severance. If she is fired for cause, she does not receive severance pay. A bonus provision is also included in the contract, payment of which is based on exceeding budgeted General Fund revenues and expending no more than amounts appropriated in the General Fund.

- Four City Council members and the Mayor serve three-year terms and are not subject to term limits. The Mayor is a voting member of the Council and conducts all Council meetings. Tenure of the Council is as follows:
  - Mayor (Running for re-election for a fourth term).
  - Councilman I (In first year of his first term).
  - Councilman II (In first year of her second term).
  - Councilman III (Running for re-election for a third term).
  - Councilman IV (In last year of his second term. Not running for re-election).

- During the past 15 years, the City has had four Finance Directors. According to the City Manager, the low pay scale and stringent experience requirements for the position deter many qualified applicants from applying. As a result, under-qualified persons have been
hired to fill the position but leave within a few years because of the work load and high level responsibilities of the position.

- The current Finance Director was hired three months ago, has never held a management position, and this is his first job with a governmental organization. Prior to joining the City, the Finance Director worked for a medium-size CPA firm in a neighboring city for four years.

- Due to budget constraints in the current year, all unfilled administrative support functions (including finance) were eliminated. Current Finance Department personnel include the Finance Director, one accounts payable clerk, one utility billing accountant, and one cashier.

- Prior year significant deficiencies included repeat comments related to improper segregation of duties, lack of succession personnel in the finance function, lack of centralized purchasing, and lack of centralized cash receipts. The Council did not address the comments due to a lack of funds.

**Questions**

1. Based on the facts above, what fraud risk factors might exist related to management override, accounting estimates and revenue recognition?

2. What specific preliminary procedures should be performed to address the fraud risks identified in Question 1?

3. What aspects of the fraud triangle should be considered in these circumstances?
Case 3-2 – Responding to Revenue Recognition as a Fraud Risk Factor

Directions and Background

Read the following facts about Healthy Families, a large not-for-profit corporation recognized under IRC Section 501(c)(3). Answer the questions below in the space provided.

You are a small tax and audit firm with 25% of gross revenues coming from audit fees. Firm personnel meeting the qualifications for audits of not-for-profit organizations include one partner and one staff accountant.

Your current audit clients are solely not-for-profit organizations with Healthy Families representing 80% of annual audit fees and 20% of all firm revenues. This is the tenth year your firm has had the audit engagement for Healthy Families. There is no formal audit contract for Healthy Families other than the engagement letter executed each year by the Executive.

Facts

The brainstorming session with all engagement staff during the preliminary audit planning stage reveals the following information:

- The CEO for Healthy Families has been in his position for 10 years and with the organization for 20 years. He was selected to serve as CEO when the previous CEO retired. The ten years prior to being promoted to CEO were spent working up from Program Coordinator, to Branch Manager, and then Vice President of Operations.

- Board positions are filled as needed when current Board members decide to leave the Board. The CEO provides the Executive Committee with the names of potential Board members. After approval by the Executive Committee, potential Board members are formally elected by the Board members at large.

- The Executive Committee is comprised of the CEO, Immediate Past President, President, Vice President, Secretary, and Treasurer. No voting power is vested in the CEO.

- There is no formal audit committee. The Executive Committee acts as both finance and audit committee.

- Healthy Families operates 20 branch locations in a five county area with oversight responsibility performed by a centrally located Administrative Office. Services provided to the Branch offices from the Administrative Office include operational oversight, training, financial accounting and reporting, human resources, marketing, and fund raising.

- Branch operations range from providing minimal services off site to providing a full range of services both on and off site. Each branch is operated by a Branch Manager and each branch is staffed with at least one program coordinator and an Office Manager.
The CEO has created a very competitive performance-based environment among the branches. As such, Branch managers and all full-time staff are eligible for annual bonuses based on the extent pre-determined performance goals have been achieved.

During the past 20 years, Healthy Families has had two Chief Financial Officers. The current CFO was hired by the incumbent CEO not long after he was selected as CEO. According to the CEO, the former CFO was demoted to Accounting Supervisor because he was unable to meet the information demands of the CEO. The former CFO retired from Healthy Families five years ago.

Administrative Office personnel and Branch Managers are compensated commensurate with prevailing market rates for similar work. Mid-management, office support, and line personnel are paid less than the market which has resulted in high turnover rates throughout Healthy Families.

Prior year significant deficiencies included repeat comments related to improper segregation of duties at the branch locations, lack of centralized purchasing, and lack of timely reconciliation of bank statements. The Executive Committee directed the CEO to address the comments as they did not wish to see them repeated. According to the CEO, he has not had time to address the comments, nor does he see a pressing need to address them since they have been repeated every year your firm has performed the audit.

**Questions**

1. Based on the facts above, what fraud risk factors might exist related to management override, accounting estimates, and revenue recognition?

2. What specific preliminary procedures should be performed to address the fraud risks identified in Question 1?

3. What aspects of the fraud triangle should be considered in these circumstances?
Chapter 4
Fraudulent Financial Reporting

Chapter Objectives
This chapter will discuss and analyze the following:

• Understand and identify the issues and concerns with respect to revenue recognition that may result in fraudulent financial reporting by governmental and not-for-profit organizations.

• Understand and identify the issues and concerns with respect to accounting estimates that may result in fraudulent financial reporting by governmental and not-for-profit organizations.

• Understand and identify the issues and concerns with respect to functional and fund classifications that may result in fraudulent financial reporting by governmental and not-for-profit organizations.

• Apply aspects of SAS No. 99 to case studies in fraudulent financial reporting by governmental and not-for-profit organizations.

• Recognize some common ways in which fraudulent financial reporting is perpetrated in governmental and not-for-profit organizations.

Overview

Fraudulent Financial Reporting and the Fraud Triangle
As we have mentioned several times, conditions under which fraud generally occurs are delineated in SAS No. 99 as the “fraud triangle.” These three conditions are incentié or pressure, opportunity, and rationalization or attitude.

A combination of these conditions frequently exists in many governmental and not-for-profit organizations. The increased potential for conditions comprising the fraud triangle increases the auditor’s responsibility with respect to fraudulent financial reporting by governmental and not-for-profit organizations. Specific areas of concern to the auditor with respect to the fraud triangle and fraudulent financial reporting are discussed in the following sections.

Incentié or Pressure
When the economy is in decline, there is often added pressure on governmental and not-for-profit organizations to provide services. Governmental organizations feel pressure to provide
more and/or higher quality services at a time when elected officials are reluctant to increase tax rates or user charges. Management of not-for-profit organizations may feel pressure to meet or exceed service level targets for both outputs and outcomes. As such, there may be an incentive to overstate revenues or to apply revenue recognition criteria that is not in accordance with generally accepted accounting principles. Even when the economy is not in a state of decline not-for-profit organizations may have an incentive to overstate revenues and/or results in an effort to obtain additional grant funds or contributions from resource providers.

**Opportunity**

The lack of personnel or the lack of sufficiently qualified personnel is prevalent in administrative and/or accounting and finance functions in both government and not-for-profit organizations. The resulting lack of, or ineffective, internal controls creates opportunities for fraud.

Governmental and not-for-profit organizations may have a number of locations taking cash in payment of services. In the case of the not-for-profit organization, significant amounts of cash may be received at either central or offsite locations. Additionally, such cash may be collected by persons, such as volunteers, lacking knowledge of existing internal controls. Lacking or ineffective controls in either type of organization create opportunities for fraud in these areas.

In the case of the governmental organization, it is highly likely the amounts of many of the revenues received in cash and/or received at off-site locations are not material to the financial statements taken as a whole. However, one of the objectives of financial reporting for governmental organizations is public accountability. Therefore, situations such as these, while not material to the financial statements, are material to public accountability.

**Rationalization or Attitude**

Employees of governmental and not-for-profit organizations are often paid less than their counterparts in the private sector. Some employees of governmental and not-for-profit organizations often rationalize the misappropriation of physical assets as compensation for their low salary levels. Again such situations may not result in material misstatements of financial amounts. They are, however, violations of the public trust and serve as a measure of accountability.

Governmental organizations typically keep the permanent employee population at the lowest level possible in an effort toward public accountability. As such, employees of governmental organizations are often over-worked or asked to work out of class without additional compensation. It is common for governmental organizations to not allow two employees to simultaneously fill the same budgeted position. This makes it next to impossible for the incumbent to train their replacement. These specific situations may create an attitude within governmental employees that may then provide them with the rationale needed to perpetuate fraud.

Employees of not-for-profit organizations may feel pressured to appear efficient and effective in order to attract donors and or to obtain grant funds. These circumstances added to the pressure to
continue to provide a high level of service may create an environment in which employees are able to *rationalize* perpetrating fraud.

**Fraudulent Financial Reporting and the Fraud Process**

The “process” of fraud is the same whether it occurs in governmental or not-for-profit organizations or for profit entities. Remember, fraud typically occurs in the following three step process:

- The fraud is *committed*.
- Perpetrators receive the benefits of the fraud.
- The fraud is *concealed*.

The auditor generally detects fraud during the “concealment” step in the three step fraud process. Concealment or lack of concealment, of fraudulent transactions is most often reflected by

- *Discrepancies in the accounting records.*
- *Conflicting or missing evidential matter.*
- *Problematic or unusual relationships between the auditor and the client.*

As discussed in previous chapters, effective methods by which to evaluate if any such noted situations might indicate material misstatements due to fraud include

- *Analytical procedures* conducted as substantive procedures as part of the overall review stage of the audit.
- *Brainstorming sessions* with all members of the audit engagement team at or near the end of the engagement to discuss the magnitude and collective significance of any such observations.

Procedures that might be employed in the overall review stage of the audit of governmental organizations to detect fraudulent financial reporting might include

- Ascertaining if any *significant budget adjustments* were made at, near, or after year end.
- Determining all budget adjustments made at, near, or after year end were properly and timely *approved by the governing body*, if required.
- Reviewing *significant interfund transactions* made at, near, or after year end.
- Considering *changes in the specific funds constituting major funds* and inquiring as to the reasons for significant changes resulting in reclassification from the previous year.
- Reviewing *responses to inquiries regarding analytical relationships* obtained throughout the engagement for vagueness, plausibility, or inconsistency with other evidence.
- Evaluating whether the *accumulated results of audit procedures and other observations* affect the previous assessments of risk related to fraudulent financial reporting.
• Ascertaining all engagement team members appropriately communicated with each other relative to conditions indicating the risk of material fraudulent financial reporting.

With respect to not-for-profit organizations, procedures that might be employed in the overall review stage of the audit of not-for-profit organizations to detect fraudulent financial reporting might include

• Ascertaining if any significant budget adjustments were made at, near, or after year end.
• Determining all budget adjustments made at, near, or after year end were properly and timely approved by the board of directors, if required.
• Reviewing significant transfers between classes of net assets made at, near, or after year end.
• Reviewing responses to inquiries regarding analytical relationships obtained throughout the engagement for vagueness, plausibility, or inconsistency with other evidence.
• Evaluating whether the accumulated results of audit procedures and other observations affect the previous assessments of risk related to fraudulent financial reporting.
• Ascertaining all engagement team members appropriately communicated with each other relative to conditions indicating the risk of material fraudulent financial reporting.

Common Schemes to Perpetuate Fraudulent Financial Reporting

There are an almost indefinite number of ways in which to perpetuate fraud through the financial reporting mechanism. As discussed previously, a number of incentives/pressures, opportunities, and rationalizations/attitudes exist with respect to fraudulent financial reporting in governmental and not-for-profit organizations.

These circumstances are exacerbated in many governmental and not-for-profit organizations due to missing or ineffective internal controls, not the least of which is management override. The most common schemes to perpetuate fraudulent financial reporting include

• Premature revenue recognition or delayed revenue recognition.
• Premature expense recognition or delayed expense recognition.

Premature Revenue Recognition or Delayed Revenue Recognition

Premature revenue recognition is most common in a for profit entity. However, the existence of certain incentives/pressures and rationalizations/attitudes coupled with opportunities also make this a potential fraud risk area in governmental and not-for-profit organizations. In governmental and not-for-profit organizations, premature recognition of revenue overstates revenues as well as assets and net assets.

More common to governmental and not-for-profit organizations than in for profit entities is the potential for delayed revenue recognition. It may seem odd that an organization would want to understate revenues of the current period. As with premature revenue recognition in governmental
and not-for-profit organizations, certain incentives/pressures and rationalizations/attitudes coupled with opportunities make delayed revenue recognition a potential fraud risk area.

Meeting budgeted amounts is critical in governmental organizations and may play a crucial role in not-for-profit organizations as well. In these cases, management may have an incentive to either recognize revenue prematurely or to delay recognition of revenue. If current year revenue estimates have not been met, an incentive to prematurely recognize revenue may exist. Conversely, if budget levels for the current year have already been achieved, an incentive to move revenue from the current period into the subsequent period may exist.

**Premature Expense Recognition or Delayed Expense Recognition**

Premature or delayed expense recognition goes hand-in-hand with premature or delayed revenue recognition. If a governmental or not-for-profit organization has an incentive or is pressured to meet certain revenue goals, the same incentives or pressures to meet expense goals may also exist.

Premature expense recognition is common in governmental and not-for-profit organizations while virtually unheard of in for-profit entities. As with delayed revenue recognition it may seem odd that an organization would want to overstate expenses of the current period. One of the most common reasons this may exist as a potential fraud risk in audits of not-for-profit organizations, and is extremely common in audits of governmental organizations, relates to incentives, rationalizations, and attitudes in these organizations.

In many governmental organizations, appropriations that are not expended by year end are lost. Having actual expenditures significantly less than appropriated amounts may negatively affect the amounts appropriated in subsequent years. This is a very common situation among governmental organizations and it has resulted in the “use it or lose it” mentality common among many of these organizations.

**Revenue Recognition**

**Issues and Concerns**

SAS No. 99 requires the auditor to consider revenue recognition with respect to the consideration of fraud in financial statement audits. Specific issues and concerns related to revenue recognition and the consideration of fraud in audits of governmental and not-for-profit organizations include:

- Overstatement of earnings/increases in net assets.
- Fictitious revenues.
- Improper application of revenue recognition principles.
- Overstatement of assets.
- Understatement of allowances for receivables.
Some typical situations or circumstances that may indicate the existence of fraudulent financial reporting due to revenue recognition issues include:

- Significant or unusual adjustments to receivables at or near year-end.
- Documentation relating to cash receipts is missing or altered.
- Cash flow from operating activities is inconsistent with actual cash flow.
- Significant or unusual entries to reconcile major revenue accounts.
- Unusual or unexplained significant fluctuations in major revenues from year to year or from budgeted amounts.
- Significant (in amount or frequency) related party transactions.
- Revenue transactions that have been pre or post dated from the actual transaction date.
- Significant journal entries made to major revenue accounts rather than flowing through from adjustments to subsidiary accounts.

**Governmental Organizations**

With respect to the consideration of fraud, *revenue recognition* may be of particular concern to the auditor of governmental organizations. In governmental organizations, revenue recognition is a function of the measurement focus and basis of accounting for a particular financial statement. With respect to revenue recognition, the auditor of governmental organizations should consider issues related to fraudulent financial reporting in the following areas:

- Non-exchange transactions.
- Grant revenues.
- Revenues of government type activities.
- Pledged revenues.

**Non-exchange Transactions**

Timing related to recognition of non-exchange transactions is based on the following four classes:

- *Derived tax revenues* – Result from assessments imposed on exchange transactions (i.e., income and sales taxes, other assessments on earnings/consumption).
- *Imposed non-exchange revenues* – Result from assessments imposed on non-governmental entities.
- *Government mandated non-exchange transactions* – Occur when a government at one level provides resources to a government at another level and requires the resources be used for a specific purpose (i.e., state or local programs that are mandated by the federal government).
- **Voluntary non-exchange transactions** – Result from legislative or contractual agreements (other than exchanges) entered into willingly by the parties to the agreement (i.e., certain grants, private donations).

Generally accepted accounting principles require a government organization to recognize non-exchange transactions unless they are

- Not measurable or
- Not probable of collection.

Classification and recognition criteria specified by generally accepted accounting principles create a number of areas where the potential for fraudulent financial reporting may occur. For example, the estimated time between the collection of local sales taxes by the vendor and the ultimate receipt of same at the local government level could be subject to a number of different interpretations. Additionally, the amount estimated to be recognized in this case could be calculated using several different assumptions.

To properly address revenue recognition in relation to the consideration of fraud in financial statement audits of governmental organizations, the auditors will need to be aware of

- The types of non-exchange transactions that exist in the governmental organization.
- When revenues from each type of non-exchange transaction are available.
- Measurement basis for each type of non-exchange transaction.
- All parties to the non-exchange transaction.
- The entity providing the resources and any contractual commitments associated therewith.
- When the government has a legally enforceable right to claim the resources.

**Grant Revenues**

Because grants are *usually non-exchange transactions*, the terms of a particular grant will dictate the recognition of assets, revenues, and expenses for purposes of financial statement reporting. However, from the perspective of fraudulent financial reporting, grant revenues provide an additional area of concern for the auditor.

In the case of *program specific grants*, the governmental organization may feel pressure from the community to demonstrate the program sustained itself with grant revenues. As such, an aggressive approach to recording grant revenues and a soft line approach to grant expenses may be adopted by the governmental organization. Such an attitude may result in material misstatements in the financial statements. If the auditor observes such a situation and determines the misstatement was intentional, then there is evidence fraud may exist.

**Revenues of Government Type Activities**

For basic financial statements prepared at the government-wide level by the governmental organization, the auditor may have a number of concerns related to revenues of government type
activities. Prior to GASB Statement No. 34, governmental organizations were not concerned with issues related to the full accrual basis of accounting with respect to governmental type funds. Additionally, there was little concern for whether functions generated functional net revenues or incurred functional net expenses. With the advent of GASB No. 34 this has changed. As such, revenue recognition issues relate to

- Proper identification of governmental and business type activities.
- Recognition of all material amounts representing full accrual transactions for governmental type activities in the government-wide statements.
- Accuracy of amounts calculated or estimated representing adjustments to fund level amounts for full accrual transactions at the government-wide level.
- Allocation of operating and/or capital grant revenues to the proper function.
- Determination of revenue sources representing charges for services and allocation of such to proper functions.

**Pledged Revenues**

Another area of concern to the auditor with respect to fraudulent financial reporting and revenue recognition by governmental organizations relates to revenues pledged as security for long-term debt. In the case of long-term debt, bond covenants may require a certain level of revenues or specify certain minimum debt service coverage ratios. Governmental organizations may have an incentive in such cases to misstate revenues in order to not appear to be in violation of their bond covenants.

**Not-for-Profit Organizations**

With respect to the consideration of fraud, *revenue recognition* may be of particular concern to the auditor of not-for-profit organizations. With respect to revenue recognition, the auditor of not-for-profit organizations should consider issues related to fraudulent financial reporting in the following areas:

- Contributions.
- Membership dues.
- Fund raising.
- Split-interest agreements.
- Grants.
- Healthcare receivables.

Analytical procedures related to revenue recognition that might prove helpful to the auditor in evaluating the risk of material misstatement due to fraud might include

- Comparing *significant changes in major revenue sources* and fund raising activities by type resource provider with those of the prior year.
Fraudulent Financial Reporting

- Reviewing **significant contributions by resource provider** and comparing them to those of the prior year.
- Comparing volume of **purchases by vendor for significant increases** from the prior year.

**Contributions**

Contributions are often significant to the total resources available to the not-for-profit organization. Not-for-profit organizations receive contributions in the form of:

- Financial resources.
- Economic resources.
- Promises to give in the future.
- Donated goods and services.

Often contributions may consist of a donor promise to give which may be **subject to donor restrictions imposing time or use restrictions** either on a temporary or permanent basis. Such contributions are required to be classified as restricted assets until the restriction has been lifted or satisfied. Given the conditions of the fraud triangle, proper classification of contributions may be a fraud risk area for the auditor of not-for-profit organizations.

Contributions constituting **promises to give by related parties** may be of special concern to the auditor with respect to fraudulent financial reporting. Many not-for-profit organizations recruit board members and other key volunteers with the understanding they will “give or get” a certain amount of contributions for the not-for-profit organization. As such, these individuals may pledge generous contributions in the form of promises to give but may slowly pay these pledges. In some cases, pledges from board members and other key volunteers may go unpaid altogether. The policies of the not-for-profit organization with respect to estimating the uncollectible portion of pledges may be inadequate in these cases which may result in material misstatements in the financial statements. This is an area that the auditor may need to consider as a fraud risk.

Another area of concern for the auditor is whether proper determinations have been made as to whether promises to give are conditional or unconditional.

**Membership Dues**

As with trade receivables of a for profit entity, receivables of not-for-profit organizations for membership dues may represent a financial reporting fraud risk. Resources from membership dues and assessments may represent a significant resource for not-for-profit organizations.

Members of not-for-profit organizations may receive tangible or intangible benefits from their membership in the organization. Therefore, membership dues or assessments may represent **exchange or non-exchange transactions or be a combination of both**. Chapter 5 of the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations* (the Guide), discusses contributions and agency transactions. Specific guidance with respect to membership transactions is found in paragraphs 5.27 and 5.28. Table 5-2 of the Guide delineates a number of indicators useful in determining the contribution and exchange portions of membership dues.
In *exchange transactions*, the not-for-profit organization must perform in order for the membership dues earnings process to be complete. For financial statement reporting, this may indicate the potential to report a portion of membership dues as deferred revenues. Improper determination of when the membership dues earnings process is complete may result in material misstatements in the financial statements of not-for-profit organizations.

The auditor should be aware of the benefits, goods, services, etc., accruing to the member in order to determine whether membership dues represent an exchange or non-exchange transaction or a combination of both.

Audit procedures related to membership dues may involve analytical procedures using non-financial information such as membership lists, attendance records, dues schedules, newsletters, etc. The risk of material misstatement of membership dues from fraud should be evaluated in light of the reliance to be placed on such non-financial data.

**Fund Raising**

Many not-for-profit organizations conduct *special events* as fund raising or joint activities. Such activities may include dinners, theater parties, seminars, conferences, etc., and attendees may or may not receive a direct benefit. Paragraphs 13.21 through 13.26 of the Guide provide guidance in this area and also include several illustrations of reporting alternatives related to special events.

For special events that are *peripheral or incidental activities* reporting such activities at net amounts (cost netted are limited to direct costs) is permitted by FASB No. 117. However, if such activities are *on-going major or central activities*, generally accepted accounting principles require revenues and expenses of these activities to be reported at gross amounts. Organizations may report the gross revenues of special events and other fund-raising activities with the cost of direct benefits to donors (for example, meals and facilities rental) displayed either (1) as a line item deducted from the special event revenues or (2) in the same section of the statement of activities as are other programs or supporting services and allocated, if necessary, among those various functions. Alternatively, the organization could consider revenue from special events and other fund-raising activities as part exchange (for the fair value the participant received) and part contribution (for the excess of the payment over that fair value) and report the two parts separately.

Accounting and financial reporting related to special fund raising/joint activities is somewhat complex and subjective. The options allowed under generally accepted accounting principles present a number of potential areas in which fraudulent financial reporting may occur. The determination of and accounting for revenues and expenses associated with special events necessitate the auditor have a thorough understanding of the event, its intended purpose and the related costs to the not-for-profit organization as well as the benefits to the attendees.

**Split-interest Agreements**

Donors may enter into trust agreements or other arrangements wherein a not-for-profit organization may receive benefits that are shared with others. Terms of these arrangements may
be revocable by the donor in certain situations. These agreements may exist for either a finite number of years, in perpetuity, or for the remaining life of a specific individual. Such agreements are usually of the following types:

- **Charitable lead trusts** – Specific distributions are made to a designated not-for-profit organization over a specified period. Upon termination, assets are paid to the donor or donor designated beneficiaries.

- **Perpetual trusts held by third parties** – An independent third party administers the trust and distributes the income to a designated not-for-profit organization in perpetuity. The not-for-profit organization has an irrevocable right to receive the income earned but never receives the assets held in trust.

- **Charitable remainder trusts** – Specific distributions are made to designated beneficiaries over a specified period. Upon termination, assets are paid to a specified not-for-profit organization.

- **Charitable gift annuities** – Specific distributions are made to the donor or his/her designees in fixed amounts for a specified time in exchange for assets contributed by the donor to the not-for-profit organization. Upon termination, assets remain with the not-for-profit organization.

- **Pooled (life) income funds** – Donor contributions are pooled and invested as a group with the donor (or his/her designee) receiving the actual income earned on his/her assigned units in the pool. Upon death of the donor, the value of the assigned units reverts to the not-for-profit organization.

Split-interest agreements present a number of revenue recognition issues for the not-for-profit organization and the auditor. These issues include

- Proper ownership of the assets included in the split-interest agreement.
- Proper valuation of the assets included in the split-interest agreement.
- Proper ownership of the earnings of the assets included in the split-interest agreement.
- Proper valuation of the earnings of the assets included in the split-interest agreement.
- Proper recognition of the liabilities assumed under the split-interest agreement.
- Proper valuation of the liabilities assumed under the split-interest agreement.

In order to determine the proper financial reporting of split-interest agreements, the auditor will need to answer the following questions:

- Is the split-interest agreement revocable by the donor?
- Does the not-for-profit have a lead or remainder interest in the split-interest agreement?
- Are there donor imposed conditions in the split-interest agreement?
- Has the split-interest agreement been properly executed by all required parties?
- Does an unrelated third party act as agent or trustee?
• Does the third party agent or trustee have variance power to redirect the benefits?
• Are the not-for-profit organization’s rights to benefits conditional?
• Is income earned on the assets held under the split-interest agreement available to the not-for-profit organization and is so is it available for use without donor imposed restrictions?
• Can the fair value of the split-interest agreement be objectively determined?
• Was the discount rate applied in estimating fair value objectively determined and consistently applied?
• Does the split-interest agreement include an embedded derivative subject to the measurement provisions of FASB No. 133, Accounting for Derivative Instruments and Hedging Activities?
• Have assets and liabilities recognized under split-interest agreements been properly disclosed in the financial statements and the notes?

Grants

Because of the large number of grants common to many not-for-profit organizations, revenue recognition may be of particular concern to the auditor with respect to fraudulent financial reporting. Generally, the terms of the particular grant will dictate the recognition of revenues and expenses for purposes of financial statement reporting.

Not-for-profit organizations feeling pressure to generate positive operating results may take an aggressive approach to recording grant revenues and a soft line approach to grant expenses. Such an attitude may result in material misstatements in the financial statements. If the auditor observes such a situation and determines the misstatement was intentional, then there is evidence fraud may exist.

Healthcare Receivables

Additional concerns related to revenue recognition and fraudulent financial reporting by not-for-profit healthcare organizations exist with respect to reimbursements from insurers and government sponsored healthcare programs. The knowing misstatement of facts that results in unfair material profit through medical coverage may constitute fraud under the provisions of SAS No. 99.

False claims by physicians, hospitals, and other healthcare providers may result in overstated revenues, receivables, or both. Ways in which false claims may result in material misstatements in the financial statements include

• Misstatement of services rendered or goods provided – Goods or services are never given or given at lesser levels than indicated on claims filed with insurers, etc.
• Upcoding – Claims contain more expensive products or services than the products or services actually provided.
• *Unbundling services* – Involves splitting charges for a comprehensive procedure with one all-inclusive charge into individual procedures/services with collectively higher charges.

• *Provision of unnecessary treatment* – Services actually rendered that are unnecessary to the proper treatment the diagnosed illness or condition.

• *Kickbacks* – Illegal incentives provided by vendors to healthcare providers (individuals or organizations) for the performance of a service.

### Accounting Estimates

#### Issues and Concerns

Fraudulent financial reporting is often the result of intentional misstatements of *accounting estimates* by management or others. Governmental and not-for-profit organizations are required to make a number of estimates for a variety of reasons. Often these estimates significantly affect amounts disclosed in their financial statements.

#### Governmental Organizations

Accounting estimates made by governmental organizations are of particular concern to the auditor with respect to the consideration of fraud. From a fraudulent financial reporting perspective, the accounting estimates made by governmental organizations of concern to auditors relate to

- Allowances for material uncollectible receivables such as taxes, special assessments, and customer receivables.
- Estimated useful lives of capital assets.
- Assessed condition of infrastructure assets if using the modified approach.
- Actuarial valuations of pension and other post-employment benefit obligations.
- Estimates of accrued compensated absences.
- Estimated contingent liabilities for litigation, claims, and assessments.
- Functional allocations of direct and indirect costs.

Additionally, auditors should be concerned with how taxable property values are calculated, if applicable. Estimates of budgeted revenues should also be reviewed for potential manipulation as well as how they compare to actual results. It is not uncommon for governmental organizations to be overly optimistic in their revenue estimates or less than generous with expenditure allocations. In these cases, the auditor is primarily concerned with public accountability with respect to

- Balanced budget requirements.
- Ability to continue to finance current services.
- Meeting bond and other debt obligations when due.
Not-for-Profit Organizations

Accounting estimates made by not-for-profit organizations are also of particular concern to the auditor with respect to the consideration of fraud. From a fraudulent financial reporting perspective, the accounting estimates made by not-for-profit organizations of concern to auditors relate to

- Allowances for material uncollectible receivables such as pledges, special assessments, dues, and customer receivables.
- Split-interest agreements.
- Estimated useful lives of capital assets.
- Estimates of accrued compensated absences.
- Estimated contingent liabilities for litigation, claims, and assessments.
- Functional allocations of expenses.
- Allocation of joint costs.

It is not uncommon for not-for-profit organizations to be overly optimistic in their revenue estimates or less than generous with expense allocations. This is especially true in small and medium not-for-profit organizations. Unlike governmental organizations, the legal level of budgetary accountability does not exist in not-for-profit organizations. Not-for-profit organizations often “balance” projected expenses with unrealistic estimates of grant and contribution revenues. In some cases, the lack of a profit motive exacerbates the lack of “realism” reflected in budgets of not-for-profit organizations.

The potential for manipulation or material misstatements may exist especially if management of the not-for-profit organization has an incentive or feels pressure to falsify results. Early in the planning stage of the audit, it is important for the auditor to ascertain

- The budgetary philosophy of the not-for-profit organization.
- Whether management is compensated based on certain performance expectations.
- If actual revenues are in line with budgeted revenues and, if not, whether expense projections have been adjusted accordingly.

Functional and Fund Classifications

Issues and Concerns

The functional classification of expenses is unique to financial reporting by governmental and not-for-profit organizations. Often the object or natural classification of a transaction is electronically allocated to pre-determined functions through the “black box” of an entity’s financial management system.
Misstatements of expenses within functions will not, in all likelihood, affect the overall change in net assets for a given period. However, expense ratios may be important to both governmental and not-for-profit organizations. This incentive, coupled with the “black box” aspect of functional allocations, increases the risk of material misstatements, whether intentional or fraudulent, in audits of governmental and not-for-profit organizations.

With respect to premature or delayed expense recognition typical situations or circumstances that may indicate the existence of fraudulent financial reporting related thereto include:

- Significant or unusual adjustments to payables at or near year-end.
- Documentation relating to cash disbursements or accounts payable is missing or altered.
- Cash flow used in operating activities is inconsistent with actual cash flow.
- Significant or unusual entries to reconcile major liability or expense accounts.
- Unusual or unexplained significant fluctuations in major liabilities or expenses from year to year or from budgeted amounts.
- Significant (in amount or frequency) related party transactions.
- Payable or expense transactions that have been pre or post dated from the actual transaction date.
- Significant journal entries made to major liability or expense accounts rather than flowing through from adjustments to subsidiary accounts.

**Governmental Organizations**

As discussed previously, use of the fund structures provides a mechanism by which governmental organizations are able to conceal, misrepresent, or manipulate transactions whether with the intent to defraud or not. Many governmental officials and employees find it easy to rationalize improper fund transactions and/or accounting for a number of reasons including the following:

- Maintains current tax levels.
- Maintains current user fee levels.
- The belief that no one understands fund accounting.
- The belief that all financial resources should be available for all operations of the governmental organization regardless of external restrictions.

Interfund transactions can conceal a number of irregularities and may result in fraudulent financial reporting if not detected. Examples of potentially fraudulent transactions include:

- Offsetting operating losses in business type activities.
- Concealing budget shortfalls.
- Infusing working capital to meet bond covenant ratios.
GASB No. 34 requires a number of disclosures related to reciprocal and nonreciprocal interfund transactions. These required disclosures may affirm there are no material misstatements or they may represent areas where the potential risk of material misstatements due to fraud may exist.

In the statement of activities, GASB Statement No. 34 requires the reporting of expenses at the government-wide level by functional classification. Functional expenses are offset by specifically identifiable grants (operating and capital) and charges for services in the government-wide level statement of activities but not offset at the fund level. At the governmental fund level, expenditures are also presented within functional, rather than natural, classifications. Some governmental agencies may misstate functional amounts to circumvent legal requirements or to comply with grant provisions or bond covenants.

**Not-for-Profit Organizations**

Under the requirements of FASB No. 117, not-for-profit voluntary health and welfare organizations report expenses by their functional and natural classifications in a matrix format. Other not-for-profit organizations are required to report expenses by functional classifications and are encouraged to provide information about their natural expense classification.

Some not-for-profit organizations may misstate functional amounts to circumvent Internal Revenue Service requirements or to comply with grant provisions or debt covenants. In some cases, not-for-profit organizations may misstate revenues by net asset classification in order to appear to have met matching requirements of grants or other donor-imposed restrictions.

For many potential resource providers, the expense ratios of not-for-profit organizations play an important role in their decision to contribute to the organization. Potential resource providers want to know if their contributions will be used in furtherance of the organization’s mission or for administrative or fund raising purposes.

Allocation of fund raising expenses is an area that represents a potential fraud risk with respect to financial reporting. Generally accepted accounting principles require all fund raising costs be expensed when incurred. Such accounting treatment is required regardless of the period in which contributions resulting from these efforts will be received. Occasionally, not-for-profit organizations misstate changes in net assets by capitalizing fund raising expenses rather than recognizing an expense when they are incurred.

**Accounting for Joint Activities**

If the criteria of purpose, audience, and content are met, the costs of a joint activity that are identifiable with a particular function should be charged to that function and joint costs should be allocated between fund raising and the appropriate program or management and general function. If any of the criteria are not met, all costs of the joint activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal),
should not be reported as fund raising. Paragraphs 13.41 through 13.55 of the Guide discuss the accounting and reporting requirements related to joint costs.

Like special events, the determination of and accounting for costs of joint activities requires a thorough understanding of the activity as well as the mission and operations of the not-for-profit organization. As such, this area may well represent a significant risk of material financial statement misstatement. *All* of the following criteria must be met in order to allocate the costs of joint activities:

- **Purpose** – Purpose of the joint activity includes accomplishing program or management and general functions.
- **Audience** – There is a rebuttable presumption that this criterion is *not met* if the audience includes prior donors or is otherwise selected based on its ability or likelihood to contribute to the not-for-profit organization.
- **Content** – The joint activity
  - Calls for specific action by the recipient that will help accomplish the mission of the not-for-profit organization (program activities) or
  - Fulfills one or more management and general responsibilities of the not-for-profit organization.

**Summary**

This chapter focuses on fraudulent financial reporting in governmental and not-for-profit organizations. It first discusses fraudulent financial reporting with respect to the fraud triangle and then in relation to the fraud process. These discussions concentrate on the specific circumstances in governmental and not-for-profit organizations that may create additional fraud risks for the auditor of these organizations.

Also this chapter identifies three major areas of concern in audits of the financial statements of governmental and not-for-profit organizations. Unique circumstances for each identified area are delineated with respect to governmental and not-for-profit organizations. The major areas of concern related to fraudulent financial reporting are

- Revenue recognition.
- Accounting estimates.
- Functional and fund classifications.

The use of case studies specific to operations of governmental and not-for-profit organizations reinforces the concepts in the chapter and the auditor’s concerns with respect to fraudulent financial reporting in these areas.
Case Examples

Case 4-1 – Fraudulent Financial Reporting in Government Organizations

Directions and Background

Read the following facts about the City of XYZ and answer the questions below in the space provided. The italicized facts represent new information while the regular font information is repeated from Case 3-1.

You are a medium-sized general-purpose firm with 15% of gross revenues coming from audit fees. Firm personnel meeting the qualifications for audits of governmental organizations include one partner, one in-charge accountant, and one staff accountant.

Only one of your current audit clients is a governmental organization and this is the first year your firm has had the audit engagement for the City of XYZ. The contract for the City of XYZ is a three year contract and includes the financial statement audit only, as a Yellow Book audit is not required.

Facts

The brainstorming session with all engagement staff during the preliminary audit planning stage reveals the following information:

- The City is a Manager/Council form of government and the current city manager has been in her current position for three years. Prior to that she served as the City’s Human Resources Director for five years. Her employment contract is renewed annually at the discretion of the City Council.

- The terms of the City Manager’s contract state she may be discharged at any time without cause but will receive six-months of salary as severance. If she is fired for cause, she does not receive severance pay. A bonus provision is also included in the contract, payment of which is based on exceeding budgeted General Fund revenues and expending no more than amounts appropriated in the General Fund.

- Four City Council members and the Mayor serve three-year terms and are not subject to term limits. The Mayor is a voting member of the Council and conducts all Council meetings. Tenure of the Council is as follows:
  - Mayor (Running for re-election for a fourth term).
  - Councilman I (In first year of his first term).
  - Councilman II (In first year of her second term).
  - Councilman III (Running for re-election for a third term).
  - Councilman IV (In last year of his second term. Not running for re-election).
• During the past 15 years, the City has had four Finance Directors. According to the City Manager, the low pay scale and stringent experience requirements for the position deter many qualified applicants from applying. As a result, underqualified persons have been hired to fill the position but leave within a few years because of the work load and high level responsibilities of the position.

• The current Finance Director was hired three months ago, has never held a management position, and this is his first job with a governmental organization. Prior to joining the City, the Finance Director worked for a medium-size CPA firm in a neighboring city for four years.

• Due to budget constraints in the current year, all unfilled administrative support functions (including finance) were eliminated. Current Finance Department personnel include, the Finance Director, one accounts payable clerk, one utility billing accountant, and one cashier.

• Prior year significant deficiencies included repeat comments related to improper segregation of duties, lack of succession personnel in the finance function, lack of centralized purchasing, and lack of centralized cash receipts. The Council did not address the comments due to a lack of funds.

• The City owns and operates a water/sewer utility that rapidly expanded its water distribution and sewer collection systems in the last five years. A new water plant was constructed last year and two additional wells were installed three years ago. Thirty-year revenue bonds were issued to finance the improvements to the water/sewer system. Improvements were made in order to attract residential and commercial development. However, due to a sluggish economy, residential development has been minimal and no commercial development has occurred.

• Three years ago, the City contracted its engineering function to two outside professional engineering firms. One firm specializes in water and sewer systems and one firm specializes in transportation. In implementing the requirements of GASB No. 34, estimates of useful lives and assessments of condition were done by these two firms.

• Five years ago the City acquired a golf course from a private developer having financial difficulties. This was a controversial issue among the then sitting Council members as well as the community. Due to the volatility of the issue, the Council approving the purchase did so with the explicit direction to City staff that the golf course be always operated at a profit. To accomplish this efficiently, the then Finance Director established an enterprise fund to account for the operations of the golf course.

• Two years ago another developer opened a world-class semi-private golf course in an adjacent city. Activity at the City’s golf course has been negatively impacted by this new course and net losses have been incurred in the current year.
Questions

1. Based on the facts above, what issues and concerns exist with respect to revenue recognition in the water/sewer utility? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to fraudulent revenue recognition?

2. Based on the facts above, what issues and concerns exist with respect to accounting estimates? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to fraudulent accounting estimates?

3. Based on the facts above, what issues and concerns exist with respect to functional and/or fund classifications for the golf course? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to fraudulent functional and/or fund classifications?
Case 4-2 – Fraudulent Financial Reporting in Not-for-Profit Organizations

Directions and Background

Read the following facts about Healthy Families, a large not-for-profit corporation recognized under IRC Section 501(c)(3). Answer the questions below in the space provided. The italicized facts represent new information while the regular font information is repeated from Case 3-2.

You are a small tax and audit firm with 25% of gross revenues coming from audit fees. Firm personnel meeting the qualifications for audits of not-for-profit organizations include one partner and one staff accountant.

Your current audit clients are solely not-for-profit organizations with Healthy Families representing 80% of annual audit fees and 20% of all firm revenues. This is the tenth year your firm has had the audit engagement for Healthy Families. There is no formal audit contract for Healthy Families other than the engagement letter executed each year by the Executive.

Facts

The brainstorming session with all engagement staff during the preliminary audit planning stage reveals the following information:

- The CEO for Healthy Families has been in his position for 10 years and with the organization for 20 years. He was selected to serve as CEO when the previous CEO retired. The ten years prior to being promoted to CEO were spent working up from Program Coordinator, to Branch Manager, and then Vice President of Operations.

- Board positions are filled as needed when current Board members decide to leave the Board. The CEO provides the Executive Committee with the names of potential Board members. After approval by the Executive Committee, potential Board members are formally elected by the Board members at large.

- The Executive Committee is comprised of the CEO, Immediate Past President, President, Vice President, Secretary, and Treasurer. No voting power is vested in the CEO.

- There is no formal audit committee. The Executive Committee acts as both finance and audit committee.

- Healthy Families operates 20 branch locations in a five county area with oversight responsibility performed by a centrally located Administrative Office. Services provided to the Branch offices from the Administrative Office include operational oversight, training, financial accounting and reporting, human resources, marketing, and fund raising.

- Branch operations range from providing minimal services off site to providing a full range of services both on and off site. Each branch is operated by a Branch Manager and each branch is staffed with at least one program coordinator and an Office Manager.
• The CEO has created a very competitive performance-based environment among the branches. As such, Branch managers and all full-time staff are eligible for annual bonuses based on the extent pre-determined performance goals have been achieved.

• During the past 20 years, Healthy Families has had two Chief Financial Officers. The current CFO was hired by the incumbent CEO not long after he was selected as CEO. According to the CEO, the former CFO was demoted to Accounting Supervisor because he was unable to meet the information demands of the CEO. The former CFO retired from Healthy Families five years ago.

• Administrative Office personnel and Branch Managers are compensated commensurate with prevailing market rates for similar work. Mid-management, office support, and line personnel are paid less than the market which has resulted in high turnover rates throughout Healthy Families.

• Prior year significant deficiencies included repeat comments related to improper segregation of duties at the branch locations, lack of centralized purchasing, and lack of timely reconciliation of bank statements. The Executive Committee directed the CEO to address the comments as they did not wish to see them repeated. According to the CEO, he has not had time to address the comments, nor does he see a pressing need to address them since they have been repeated every year your firm has performed the audit.

• During your interim field work, Healthy Families received a grant award notice from the State Department of Children and Families. The $1,000,000 grant is for the State’s fiscal year which starts next July 1 and will be on a reimbursement basis.

• Year end for Healthy Families is December 31. Many of the branch program coordinators will be responsible for implementing and running the new grant program. As such, the CEO directed the CFO to record a portion of their current year salaries and benefits as reimbursable by the State as of this December 31.

• In prior years, the CFO has estimated 30% of the pledges receivable on capital campaigns will be uncollectible. This year, the estimate of uncollectible capital campaign pledges receivable has been reduced to 5%. The staff accountant on the audit engagement did not notice the change because the total amount of the subsidiary allowance account was similar to the prior year amount in total.

• All branch personnel are directly involved in the annual fund raising appeal conducted each February. More than half of their time in February is entirely devoted to various aspects of the fund raising campaign. The CFO does not believe it is necessary to classify this time as fund raising expenses as such activities are inherent in everyone’s job description.
Questions

1. Based on the facts above, what issues and concerns exist with respect to revenue recognition? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to fraudulent revenue recognition?

2. Based on the facts above, what issues and concerns exist with respect to accounting estimates? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to fraudulent accounting estimates?

3. Based on the facts above, what issues and concerns exist with respect to functional and/or fund classifications? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to fraudulent functional and/or fund classifications?
Chapter 5
Misappropriation of Assets

Chapter Objectives
After completing this chapter you should be able to

- Understand and identify the issues and concerns with respect to procurement and contracting that may result in misappropriation of assets by governmental and not-for-profit organizations.

- Understand and identify the issues and concerns with respect to cash receipts and disbursements that may result in misappropriation of assets by governmental and not-for-profit organizations.

- Understand and identify the issues and concerns with respect to personnel costs that may result in misappropriation of assets by governmental and not-for-profit organizations.

- Understand and identify the issues and concerns with respect to property, plant, and equipment that may result in misappropriation of assets by governmental and not-for-profit organizations.

- Understand and identify the issues and concerns with respect to program benefits and assets that may result in misappropriation of assets by governmental and not-for-profit organizations.

- Apply requirements of SAS No. 99 to case studies related to the misappropriation of assets by governmental and not-for-profit organizations.

- Recognize some common ways in which fraud from misappropriation is perpetrated in governmental and not-for-profit organizations.

Overview
Misappropriation of assets is commonly referred to as theft or defalcation and involves the actual theft of an entity’s assets. In the consideration of fraud in financial statement audits, the effect of theft results in material misstatements in the financial statements. Individuals involved in the theft of publicly owned assets belonging or entrusted to a governmental organization may face civil or criminal charges if caught. Thefts of assets owned by not-for-profit organizations may carry the same penalties especially if such assets were purchased with government financial assistance.
Assets subject to misappropriation in governmental and not-for-profit organizations include the following:

- **Cash.**
- **Cash equivalents,** such as food stamps, tuition vouchers, lottery tickets, etc., either processed or kept as inventory.
- Legally **confiscated items.**
- Inventories of supplies, etc., and physical assets that are
  - Small in size.
  - High in value.
  - High in consumer demand.
  - Easily convertible to cash.
  - Lacking in ownership identification.
- **Equipment that is subject to personal or non-program use,** such as cellular phones, digital cameras, computers, vehicles, tools, etc.
- **Physical assets susceptible to personal use or redirection,** such as unused or out-of-the-way buildings, vacant land, obsolete equipment, abandoned assets, etc.

According to SAS No. 99, the theft of assets typically occurs in a number of ways including

- **Embezzlement** of receipts.
- **Stealing** assets.
- Causing an entity to **pay for goods or services that have not been received.**

The misappropriation of assets is often accomplished by circumventing controls and may be accompanied by

- **False records or documents.**
- **Misleading records or documents.**

Because of the public nature of governmental and not-for-profit organizations, the misappropriation of assets may have a more far reaching impact than if such defalcations occurred in a for-profit entity. Public response to fraud in governmental and not-for-profit organizations may be extremely negative regardless of the monetary amount of the theft or defalcation. Therefore, the potential impact of theft and defalcations in governmental and not-for-profit organizations may be significant without being material to the financial statements taken as a whole. The auditor of governmental and not-for-profit organizations may feel the need to include audit procedures appropriate to address these concerns.
Misappropriation of Assets and the Fraud Triangle

To reiterate, the three conditions that comprise the fraud triangle are incentive or pressure, opportunity, and rationalization or attitude.

These conditions individually or in combination frequently exist in many governmental and not-for-profit organizations. The increased potential for conditions comprising the fraud triangle increases the auditor’s responsibility with respect to misappropriation of assets by governmental and not-for-profit organizations. Specific areas of concern to the auditor with respect to the fraud triangle and the misappropriation of assets are discussed in the following sections.

Incentive or Pressure

Employees of governmental and not-for-profit organizations are often paid less than their counterparts in the private sector. Additionally, employees of governmental and not-for-profit organizations have historically received annual increases in their compensation far below those of employees in the private sector. In some cases, annual salary increases for governmental and not-for-profit organizations are less than the annual increase in the consumer price index.

It is rare indeed for employees of governmental organizations to be complimented directly or appreciated indirectly by citizens of the communities they serve. Unfortunately, this lack of respect for employee needs and inadequate recognition of employee efforts also extends to management and elected officials in a number of governmental organizations. The needs of employees in not-for-profit organizations that are not direct service providers are unknown to service beneficiaries and often ignored by management and board members.

Inadequate compensation levels, coupled with an attitude of indifference by management and/or members of governing bodies, may create an incentive for employees of governmental and not-for-profit organizations to commit fraud. In such circumstances, employee fraud can often occur through the misappropriation of assets.

Opportunity

The lack of personnel or the lack of sufficiently qualified personnel is prevalent in administrative and/or accounting and finance functions in both government and not-for-profit organizations. The resulting lack of, or ineffective, internal controls creates opportunities for fraud.

Rationalization or Attitude

Factors providing an incentive for employees of governmental and not-for-profit organizations to commit fraud also provide the rationalization for such acts. Because employees of governmental and not-for-profit organizations are often paid less than their counterparts in the private sector they may rationalize the misappropriation of physical assets as compensation for their low salary levels. When employees of governmental and not-for-profit organizations are continually over-worked or asked to work out of class without additional compensation they may rationalize fraudulent acts as compensation for these additional hours or efforts.
In many governmental and not-for-profit organizations an attitude may be present that encourages employees to use assets of the organization for their personal gain. This may be as insignificant as management turning a blind eye to use of copiers for personal use or as egregious as operating a personal business from the fire station. While such situations may not result in material misstatements due to the misappropriation of assets, they are, however, violations of the public trust.

**Misappropriation of Assets and the Fraud Process**

As discussed in other chapters, the “process” of fraud is the same whether it occurs in governmental or not-for-profit organizations or for-profit entities. As a reminder, fraud typically occurs in the following three step process:

- The fraud is **committed**.
- Perpetrators receive the benefits of the fraud.
- The fraud is **concealed**.

Typically the auditor detects fraud during the “concealment” step, which most often results from

- *Discrepancies in the accounting records.*
- *Conflicting or missing evidential matter.*
- *Problematic or unusual relationships between the auditor and the client.*

Effective methods by which the auditor may evaluate whether any such noted situations might indicate material misstatements due to fraud include

- *Analytical procedures* conducted as substantive procedures as part of the overall review stage of the audit.
- *Brainstorming sessions* with all members of the audit engagement team at or near the end of the engagement to discuss the magnitude and collective significance of any such observations.

Analytical procedures as substantive procedures are often effective when employed in the overall review stage of the audit. Such analytical procedures performed to detect material misstatements due to misappropriation of assets are similar to those used to identify fraudulent financial reporting. The following such analytical procedures are appropriate in audits of both governmental and not-for-profit organizations:

- Reviewing responses to inquiries regarding analytical relationships obtained throughout the engagement for vagueness, plausibility, or inconsistency with other evidence.
- Evaluating whether the accumulated results of audit procedures and other observations affect the previous assessments of risk related to fraudulent misappropriation of assets.
- Ascertaining that all engagement team members appropriately communicated with each other relative to conditions indicating the risk of material fraudulent misappropriation of assets.
For audits of financial statements of governmental organizations the following specific procedures might be appropriate in the overall review stage of the audit to detect fraud due to the misappropriation of assets:

- Ascertain if any significant budget adjustments were made at, near, or after year-end.
- Determine whether all budget adjustments made at, near, or after year-end were properly and timely approved by the governing body, if required.
- Compare volume of purchases by vendor for significant increases from the prior year.
- Review adjustments to perpetual fixed asset inventory records based on current year physical counts.
- Comparing prior year and current year activity for number and amount of write offs for
  - Significant bank reconciling items.
  - Significant uncollectible receivables.
  - Significant supplies inventory adjustments.
  - Significant sales of property, plant, and equipment.

With respect to not-for-profit organizations, procedures that might be employed in the overall review stage of the audit of not-for-profit organizations to determine whether assets have been misappropriated might include

- Ascertaining if any significant budget adjustments were made at, near, or after year end.
- Determining whether all budget adjustments made at, near, or after year end were properly and timely approved by the board of directors, if required.
- Reviewing significant transfers between classes of net assets made at, near, or after year end.
- Comparing volume of purchases by vendor for significant increases from the prior year.
- Reviewing adjustments to perpetual fixed asset inventory records based on current year physical counts.
- Ascertaining disposition of physical assets donated to the organization during the current year.
- Comparing prior year and current year activity for number and amount of write offs for
  - Significant bank reconciling items.
  - Significant uncollectible receivables.
  - Significant supplies inventory adjustments.
  - Significant sales of property, plant, and equipment.
Common Schemes to Misappropriate Assets

As with fraudulent financial reporting, there are an almost infinite number of ways in which to perpetrate fraud through the misappropriation of assets. As discussed previously, a number of incentives/pressures, opportunities, and rationalizations/attitudes exist with respect to fraud through the misappropriation of assets in governmental and not-for-profit organizations.

These circumstances are exacerbated in many governmental and not-for-profit organizations due to missing or ineffective internal controls, not the least of which is management override. The most common schemes to perpetrate fraud due to misappropriation of assets are discussed in detail in the following sections. Included is fraud due to misappropriation of assets in the following areas:

- \textit{Procurement and contracting} frauds.
- Embezzlement of \textit{cash receipts and fraudulent disbursements} (including accounts receivable frauds).
- \textit{Personnel} frauds.
- Diversion of \textit{physical assets} including property, plant, and equipment.
- Diversion of \textit{program benefits and assets}.

Procurement and Contracting

Issues and Concerns

Onerous procurement and contracting requirements exist in most governmental organizations. Such procedures and requirements may exist in not-for-profit organizations to a lesser degree. Procurement and contractor fraud have been identified as the two most significant and costly types of fraud in government organizations. Whether intentional or not, it is the taxpayer who pays when governmental organizations are the victims of procurement or contract scams. In not-for-profit organizations it is the individual donor or government grantor that bears the cost of such fraud.

Common indicators of the potential for the misappropriation of assets due to procurement and/or contracting fraud include

- Unusual vendor names and addresses.
- Copies of invoices, purchase orders, or receiving documents rather than original documentation.
- Orders for materials/supplies already on hand in sufficient quantities or that are scheduled for disposal/discontinued use due to obsolescence.
- Orders for materials/supplies not consistent with the operations and/or mission of the government or not-for-profit organization.
- Delivery addresses different than the purchaser’s physical locations.
• Purchases falling just below the threshold for required next-level approval (in quantity or amount).
• Split purchases using purchase orders, vendor invoices, change orders, etc.
• Payments to vendors not on approved vendor lists.
• Signature of management or supervisory personnel on documents typically signed by subordinate personnel.
• Supplier/contractors receiving significant amounts of business from the organization.
• Prices in excess of market or expected market especially when large quantities are ordered.
• Complaints from vendors/suppliers regarding not being allowed to bid, stringent bid specifications or procedures, inadequate time allowed for responding to bid requests.
• Contract award patterns that may indicate bids are being rotated.
• Low quality combined with high prices including high product failure/return rates.
• Sole source procurements in significant number or without adequate justification.

**Procurement**

A number of controls related to procuring goods and services may be in place in governmental or not-for-profit organizations. Unfortunately, the lack of adequate numbers of sufficiently competent administrative and/or finance staff significantly affects the effectiveness of procurement controls. Ideally, procurement controls typically ensure purchases are made

• For approved purposes.
• In reasonable quantities.
• At competitive prices.
• From qualified and reputable vendors.

The use of procurement cards by governmental and not-for-profit organizations has increased significantly in recent years. Procurement cards minimize the burden of tedious purchasing controls and requirements and eliminate administrative paperwork as well. Therefore, a growing number of governmental and not-for-profit organizations are using procurement cards for routine and/or small purchases. Unfortunately, not all governmental and not-for-profit organizations have effective controls in place to ensure proper use of these purchasing cards.

**Contracting**

Generally, governmental and not-for-profit organizations enter into contracts covering an extended time period and/or involving significant amounts of human, capital, and/or financial resources. As such, stringent controls and procedures similar to those existing over the regular procurement of goods and services may exist in governmental and not-for-profit organizations. Unfortunately, as with procurement procedures and controls, the lack of adequate numbers of
sufficiently competent administrative and/or finance staff significantly affects the effectiveness of contracting controls.

Controls governing contracting by governmental and not-for-profit organizations are typically designed to eliminate the following:

- **Bribery** in the contract.
- **Collusion** among:
  - Contractors.
  - The contractor and the governmental or not-for-profit organization.
  - The contractor and employees of the governmental or not-for-profit organization.
- **False or double billing**.
- **False certification of quality** of parts or test results.
- **Substitution of parts**, imitation, or otherwise inferior.

**Governmental Organizations**

Controls and procedures related to procurement and contracting by governmental organizations are usually more prevalent and more effective than those found in not-for-profit organizations.

In most governmental organizations, procurement and contracting procedures constitute legal requirements. These legal requirements may address such areas as

- Goods or services requiring a competitive bid or proposal process.
- Dollar thresholds requiring a competitive bid or proposal process.
- Dollar thresholds requiring a certain number of verbal or written quotes.
- Specific vendors not qualified to provide goods and/or services to governmental organizations within a certain jurisdiction.
- The number and content of required legal notices/advertisements for requested bids and/or proposals.
- The lowest level at which bids or contracts may be awarded to successful bidders or proposers.
- The definition of related parties for specific types of governmental organizations.

Violations of such procurement and/or contracting requirements may equate to breaking the law and therefore be subject to civil or criminal prosecution. Procurement and/or contracting procedures and requirements may be mandated by any or all of the following:

- State statutes.
- Local ordinance.
Misappropriation of Assets

- Local resolution.
- Local approved/adopted policy.

Not-for-Profit Organizations

Controls and procedures related to procurement and contracting by not-for-profit organizations are usually less prevalent and may be less stringent than those found in governmental organizations. However, with respect to expenditures of funds received under federal or other governmental financial assistance programs, not-for-profit organizations may be required to meet procurement and/or contracting procedures that exceed their own internally adopted policies.

Related party transactions represent another area wherein misappropriation of assets may occur in not-for-profit organizations. These types of transactions may be especially prevalent in small to medium-sized not-for-profit organizations or in those organizations with loose, missing, or ineffective controls over procurement and contracting.

Cash Receipts and Fraudulent Disbursements

Issues and Concerns

As with for-profit entities, an opportunity for the misappropriation of assets exists in governmental and not-for-profit organizations whenever cash is collected at or disbursed from a number of locations. Also of concern in the consideration of fraud with respect to cash receipts and disbursements is the effectiveness of controls over disbursement transactions initiated at off-site locations.

Many of the audit concerns associated with the consideration of fraud with respect to cash receipts and disbursements relate to missing or ineffective controls. Because administrative and/or finance and accounting personnel in governmental and not-for-profit organizations are often limited in number or expertise, this is of special concern for the auditor of these organizations.

Common indicators of potential fraud from the misappropriation of cash, accounts receivable fraud, and inventories include

- **Cash receipts and disbursements**
  - Missing or out-of-sequence blank checks.
  - Significant bank reconciling items without reasonable explanation.
  - Second payee or unusual endorsements on checks.
  - Missing cancelled checks.
  - Unusual disbursement transactions or transactions lacking sufficient supporting documentation.
– Citizen/customer complaints about amounts they owe the organization (for taxes, services rendered, contribution pledges, etc.).

- **Accounts receivable**
  – Unexplained differences noted on receivable confirmations received.
  – Significant or unusual adjustments to receivable records.
  – Amounts deposited that are inconsistent with amounts due.
  – Significant credit balances in receivable accounts.

- **Inventories**
  – Significant inventory shrinkage.
  – Unusual inventory turnover.
  – Significant unusual or unexplained entries to control or subsidiary inventory records.
  – Significant unusual or unexpected relationships in inventory and inventory related ratios.
  – Receiving reports differing from purchase orders, contracts, or vendor invoices.

**Governmental Organizations**

Governmental organizations often receive cash at a number of locations, such as courthouses, recreation centers, police departments, utility departments, libraries, health clinics, etc. The lack of sufficient support staff at these off-site locations exacerbates the effect of lacking or ineffective controls that may exist at these locations. A number of opportunities for the misappropriation of assets may be present in these locations.

Due to relative materiality, it is possible that in some governments diversion of cash receipts may not be a fraud risk area from the perspective of misappropriation of assets. However, one of the objectives of financial reporting for governmental organizations is public accountability. Situations such as these, while not material to the financial statements, are material to public accountability.

**Not-for-Profit Organizations**

Fraud through the misappropriation of cash may be of particular concern to the auditor of not-for-profit organizations. More prevalent than in governmental organizations, is the lack of sufficient support staff on or at off-site locations of not-for-profit organizations. In addition, not-for-profit organizations often utilize volunteers in administrative and/or fund raising activities. These volunteers may be responsible for collecting large amounts of cash. This type of situation, together with generally lacking or ineffective controls, creates a number of opportunities for the misappropriation of assets in not-for-profit organizations.
While not cash receipts or disbursements, *services contributed* to or on behalf of not-for-profit organizations might also be subject to misdirection and/or inappropriate utilization. Employees at certain levels of a not-for-profit organization might be in a position to ask the donor of professional services to also perform similar services for them personally. Contributed trade-type services such as electrical, plumbing, or HVAC are often actually performed by line-level employees rather than the person committing their organization to providing such services. In these cases, there is an increased opportunity for redirection of these services for the personal use of employees of the not-for-profit organization.

**Personnel Costs**

**Issues and Concerns**

**Significance of Personnel Costs**

Governmental and not-for-profit organizations primarily provide services rather than produce goods. Accordingly, a *significant amount of expenditures/expenses* in these organizations relate to personnel costs. In this matter, as with other fraud risk areas, the lack of adequate or sufficiently knowledgeable administrative and/or finance and accounting staff may result in lacking or ineffective controls.

As discussed previously, employees of governmental and not-for-profit organizations are *typically paid less* than their counterparts in the private sector. To compensate, they may add hours to their time sheets that were not actually worked. At certain levels of management, if controls are missing, ineffective, or capable of override, it may be possible to create “fictitious employees.”

**Personnel Costs and the Fraud Triangle**

In addition to historically lower salary levels, employees of governmental and/or not-for-profit organizations are *subject to layoffs and/or reduced hours* when resources are insufficient to maintain existing services. Work force reductions may also occur when significant grant funds are discontinued and alternative funding is not available to continue the program. This unstable work environment in governmental and not-for-profit organizations may

- *Pressure* employees to work another job while on the clock for the governmental or not-for-profit organization.
- Create *incentives* for employees to look for ways to misappropriate assets either through the personnel system or other venues.

Common indicators of the potential for the misappropriation of assets due to personnel fraud include

- Unusual or second-party endorsements on payroll checks.
- Employees without the usual withholdings related to employer provided or offered benefits (i.e., insurance, retirement, savings bonds, etc.).
Guide to Fraud in Governmental and Not-for-Profit Environments

- Missing, unusual looking, or altered time and attendance records in general or frequently for the same employee(s).
- Time and attendance records signed by someone other than the usual supervisor in general or frequently for the same employee(s).

**Exempt and Not-Exempt Employees**

The issue of classifying employees as exempt or not exempt from Department of Labor regulations is often an issue in governmental and not-for-profit organizations. This is especially true in most small and many medium-sized governmental or not-for-profit organizations.

Classifying an employee as exempt when their essential duties do not meet federal guidelines for such classification results in the employee being underpaid with respect to overtime hours worked. When employees are classified as not-exempt when their essential duties do not meet federal guidelines for such classification results in employees being overpaid with respect to overtime hours worked. These situations, if intentional and material, result in fraud with respect to the audits of the financial statements of governmental and not-for-profit organizations. Material misstatements in the financial statements relate to both financial reporting and the misappropriation of assets.

In these situations misstatements in financial reporting occur due to contingent liabilities related to underpaying employees, including

- *Unpaid overtime and related benefits* – Including social security/Medicare, pension/retirement matching contributions, unemployment taxes, etc.
- *Penalties and interest* – Including those assessed by federal, state, and/or local regulatory authorities.

When employees are overpaid due to being incorrectly classified as not exempt from overtime regulations, assets of the governmental or not-for-profit organization are misappropriated. Employment-related benefits calculated on gross pay will also result in misappropriated assets. This situation is exacerbated if employees are reporting overtime hours for hours they did not actually work.

**Hiring Procedures and Controls**

Hiring procedures and controls in governmental and not-for-profit organizations may create opportunities for fraud due to the misappropriation of assets. Governmental or not-for-profit organizations may or may not be aware of the myriad of federal and state regulations governing hiring, paying, and disciplining employees. Again, the lack of qualified administrative and/or finance and accounting personnel typically contribute to missing or ineffective controls in these areas also.

Because of the generally less than market wages paid to employees of governmental and not-for-profit organizations, applicants may overstate their qualifications in order to be paid more or to be hired in higher level positions. Lower wages may also discourage qualified applicants and attract applicants with questionable backgrounds or those who may lack experience or legal
resident status. This may be especially apparent in areas such as road, building, or grounds maintenance in governmental organizations and in custodial, child care, or food service positions in not-for-profit organizations. Intentional avoidance of prudent hiring and screening procedures may represent a fraud risk area in financial statement audits of governmental and not-for-profit organizations.

*Principle federal regulations* governing hiring procedures, work conditions, and payment for hours worked in governmental and not-for-profit organizations include

- **Americans with Disabilities Act (ADA)** – Relates to discrimination in hiring persons in protected classes (among many other areas).
- **Occupational Safety and Health Act (OSHA)** – Relates to safety conditions in the workplace.
- **Department of Labor standards** – Relates to hours worked, overtime, work status, etc.
- **Department of Immigration and Naturalization** – Relates to work status of persons not considered U.S. citizens.
- **Davis-Bacon Act** – Relates to prevailing wage rates to be paid on federally funded or assisted construction projects.

**Governmental Organizations**

As stated in the previous section, Department of Labor regulations require overtime pay for hours worked in excess of the standard work week. In for-profit entities the standard work week is typically considered to be 40 hours. For governmental organizations the standard work week may be something other than 40 hours for a significant number of employees. Such employee groups typically include

- **Public safety employees** – Law enforcement, corrections, fire, and rescue.
- **Public health** – Staff at public hospitals and clinics, medical examiners, etc.
- **Public works** – Utility plant operators, road crews, building maintenance, etc.

When the number of hours in a standard work week is purported to be something other than 40, the auditor should be aware of the precedents that support the standard hours used for each employee group. When no legal precedent exists to support the standard hours used by the governmental organization a misappropriation of assets may have occurred (employees overpaid) or contingent liabilities may exist (employees underpaid).

Paid overtime may create a material incentive for employees to misappropriate assets through manipulation of the control system. For example, fire personnel in local government organizations typically work a 24-hour shift and then are off duty for the next 48 hours. In this situation, there are usually 56 standard hours in the work week but because the end of the work week and/or pay period spans two different days, overtime hours may be considered in the context of a two or three week period. When other fire personnel are ill, on vacation, or participating in training, it is necessary to replace them with other qualified fire personnel in order to maintain mandated minimum staffing levels. The result is that fire personnel often work several 24-hour overtime shifts in any given pay period.
Doing the math, it is easy to see that a number of 24-hour shifts at overtime rates may quickly create a material financial statement effect. When fire personnel work in collusion with each other to “take” vacation or to “call in” sick, fraud due to misappropriation of assets may be present. Auditors should be cognizant of the potential for fraud due to these types of circumstances. An effective audit procedure in these circumstances is to compare annual W-2 earnings by employee to adopted compensation levels for their respective positions. Variances can then be reviewed for reasonableness. Budget to actual comparisons are also effective.

Again, it is important for auditors to understand the individual laws in this area for the particular location they are working in. Information can be obtained from the Department of Labor (www.dol.gov) and the state and/or local regulatory bodies where the client is located.

**Not-for-Profit Organizations**

With respect to the consideration of fraud in financial statement audits of not-for-profit organizations personnel administration is significant because

- Personnel costs are typically material to the financial statements taken as a whole.
- Conditions related to the receipt of federal (or other government) financial assistance require prudence in personnel administration.
- Amounts reimbursable under federal contracts or programs may be erroneously stated due to lacking or ineffective personnel controls and procedures.
- Improper applicant screening may result in wrongly placing dishonest employees in positions having access to assets susceptible to misappropriation.

Nepotism is often common in not-for-profit organizations especially those that are small- or medium-sized. In these cases nepotism may exist because family members of board members are hired or because family members of other employees are hired. It is also possible that such persons are hired

- To fill positions specifically created for them.
- At salaries exceeding prevailing market rates.
- For positions requiring skills far beyond those they actually possess.

Whatever the circumstances, the existence of nepotism in hiring practices theoretically creates opportunities for collusion that may result in misappropriation of assets. Additionally, nepotism may result in misappropriation of assets because employees were hired unnecessarily or at salaries not commensurate with their abilities or that exceeded prevailing market rates.

**Property, Plant, and Equipment**

**Issues and Concerns**

Generally, property, plant, and equipment subject to misappropriation in governmental and not-for-profit organizations includes physical assets that are

- Small in size.
Misappropriation of Assets

- High in value.
- High in consumer demand.
- Easily convertible to cash.
- Lacking in ownership identification.
- Subject to personal or non-program use (i.e., cellular phones, digital cameras, computers, vehicles, tools, etc.).
- Susceptible to personal use or redirection (i.e., unused or out-of-the-way buildings, vacant land, obsolete equipment, abandoned assets, etc.).

Applying the guidance in SAS No. 99, the misappropriation of physical assets may occur through

- Stealing the assets.
- Causing the entity to pay for goods or services that have not been received or that do not meet required specifications.

The misappropriation of physical assets is often accomplished by circumventing controls and may be accompanied by

- False records or documents.
- Misleading records or documents.

In addition to the consideration of controls related to procurement, contracting, and cash disbursements the auditor should consider physical controls over property, plant, and equipment. Such procedures should be evaluated with respect to the potential for fraud due to misappropriation of the physical assets of the governmental or not-for-profit organization.

**Governmental Organizations**

*Unauthorized Use*

One of the primary concerns in audits of governmental organizations related to physical assets is determining if they were used inappropriately. This includes redirecting the use of physical assets to another government function or for personal gain.

In the case of assets wholly or partially acquired or constructed with federal financial assistance redirecting the use of such assets may have significant repercussions. Often these physical assets may be used only for purposes specifically included in the grant agreement. Therefore, if the use of such an asset is to be redirected to another bona fide governmental function, permission of the grantor may be required in advance. Without such permission, provisions of the original grant agreement may require the governmental organization to return ownership and control of the asset to the granting agency. If unintentional, redirections of this type would not appear to result in a fraudulent transaction.

Assets confiscated in law enforcement activities are often allowed under some state statutes to be redirected for the use of law enforcement. Typically, these assets are allowed to be used in the
edification or enhancement of specific or any law enforcement activities. Unfortunately, assets confiscated in law enforcement are often subject to inappropriate misappropriation the results of which are usually seen on the evening news.

It is difficult to design efficient and effective audit procedures to detect the misappropriation of publicly owned physical assets for personal use or gain. In many cases it may be necessary for the auditor to rely on internal systems of control to provide assurance related to the proper use of publicly owned physical assets.

Inquiry of appropriate personnel within the governmental organization may provide sufficient audit evidence related to the appropriate use of physical assets. However, it may be necessary for the auditor to design additional audit procedures. One procedure to consider is the observation of physical assets in use during scheduled work hours within and throughout the jurisdiction of the governmental organization. These observations could be compared to the “official” policies related to use with discrepancies discussed with appropriate client personnel. From these follow up discussions, the auditor should be able to ascertain management’s “attitude” regarding personal use of publicly owned assets whether considered de minimis or flagrantly abusive.

**Periodic Physical Inventory**

Many states mandate an annual physical inventory of and accounting for the property, plant, and equipment owned by local governments. In many cases, a certain dollar threshold for this inventory and accounting is stated in the enabling legislation.

Local governmental organizations may also have their own adopted policies and procedures related to accounting for property, plant, and equipment. Such local policies and procedures may exceed the requirements of state mandates in some cases. Even though a periodic accounting of physical assets may be state mandated or locally required, it may not occur.

Some local governments lack adequate personnel to effectively administer a property control function or to conduct an annual inventory of its physical assets. In other governmental organizations, adequate personnel may exist to affect a property control function but the attitude of the organization precludes minimal efforts (i.e., annual inventory) of control. The auditor would ascertain the reasons a governmental organization does not conduct at least an annual inventory of and accounting for its physical assets, whether mandated or not. These reasons would be evaluated in light of the potential fraud risk associated with the misappropriation of physical assets.

**Identification and Control Systems**

A common control technique to account for physical assets owned by governmental organizations is to “tag” the asset with some sort of a permanent tag or marking. The tag may show the inventory control number alone or additional information such as location, manufacturer, date acquired, maintenance schedule, etc.

Obviously the effectiveness of a “tag” system will vary from one governmental organization to another. The auditor should evaluate the effectiveness of any tag systems in light of the fraud risk associated with the misappropriation of physical assets.
Sales and Disposals

Governmental organizations typically have stringent controls and legal requirements related to the sale or disposition of publicly owned physical assets. Unfortunately, lacking or ineffective controls often exist with respect to sales and disposals of physical assets. Depending on the governmental organization, controls over sales and disposals of physical assets may apply to not only large and/or high dollar items but also to the smallest and/or low dollar items. These controls typically include

- Formal declaration by the governing body as to the surplus or obsolescence of physical assets.
- Making sales of surplus/obsolete physical assets available to the public.
- Conducting sales of surplus/obsolete physical assets through a public auction using an independent auctioneer.
- Required advertising of the public auction including date, time, and place.

Not-for-Profit Organizations

Unique to the consideration of fraud in financial statement audits of not-for-profit organizations is the issue of contributed physical assets. Valuable and sometimes significant physical assets are contributed on behalf of, or for the benefit of, the not-for-profit organization or the clients it serves. Without effective controls over these types of contributions, it is possible for them to be misdirected and/or misappropriated. This is of special concern when a not-for-profit organization has a number of locations or affiliates.

As with assets of governmental organizations, redirecting of assets wholly or partially acquired or constructed with federal financial assistance by not-for-profit organizations may also have significant repercussions. Sometimes these physical assets may be used only for purposes specifically included in the grant agreement. Therefore, if the use of such an asset is to be redirected to another bona fide function of the not-for-profit organization, permission of the grantor may be required in advance. Without such permission, provisions of the original grant agreement may require the not-for-profit organization to return ownership and control of the asset to the granting agency. If unintentional, redirections of this type would not appear to result in a fraudulent transaction.

Diversion of Program Benefits and Assets

Issues and Concerns

Assistance programs funded by or offered through governmental or not-for-profit organizations offer very valuable benefits or assets to qualified beneficiaries. As such, they are highly susceptible to fraud, waste, and/or abuse. When fraud occurs through the diversion of these program benefits and/or assets, the governmental or not-for-profit organization is definitely harmed. More important, however, is the harm caused to the intended beneficiaries of the program.

Government and not-for-profit organizations are involved in a number of programs designed to benefit thousands of individuals. In many cases, federal funds are used to operate in total or in
part numerous programs offered through governmental and not-for-profit organizations. Some programs typical of those provided by many government and not-for-profit organizations include

- Unemployment benefits.
- Food stamps.
- Housing assistance (ownership, renters).
- Financial aid for students.
- Health care.
- Job training.
- Legal assistance.
- Child care.

In most cases, these monies are awarded as grants and the grant contract includes onerous compliance requirements. Lack of compliance with the grant provisions may result in the recipient governmental or not-for-profit organization having to repay the funds to the grantor. Therefore, an integral part of financial statement audits of governmental and not-for-profit organizations relates to grant compliance requirements.

When federal funds are not spent in accordance with grant provisions, monies received under the grant become contingent liabilities of the recipient organization. As such, compliance testing is significant to not only the federal financial assistance financial statements but the basic financial statements as well.

Potential fraud risk factors related to benefit programs sponsored by or offered through governmental and not-for-profit organizations include

- Pressure from constituent or special interest groups.
- Potential for programs to generate net revenues.
- Pressure to “use or lose” budgeted amounts or grant awards.
- Physical access to program benefits and/or assets including:
  - Highly marketable and/or easily convertible assets (i.e., supplies, food stamps, vouchers, etc.).
  - Ability to draw down cash using letters of credit.
- Decentralized outreach, intake, and/or eligibility certification processes.
- Self-monitoring responsibilities due to delegation of such from funding agencies.
- Complex funding and reimbursement arrangements or restrictions including
  - Compliance and eligibility rules based on household size, income, etc.
  - Use of third parties in determining or dispensing benefits.
  - Administrative cost allowability, cost sharing, and matching.
Misappropriation of Assets

- **Insufficient resources available for or devoted to monitoring and oversight** of subrecipients.

Common indicators of the potential for the misappropriation of assets due to the diversion of program benefits and assets include

- Copies of or missing application forms and underlying supporting documentation.
- Participant files lack required information (i.e., interview sheets, tax returns, etc.).
- Decentralized intake centers or centralized intake centers with little or no monitoring by management or supervisory personnel.
- Inadequately trained and/or supervised program personnel.
- Inadequate or ineffective controls over program assets.
- Lack of periodic physical inventories of program assets.

**Governmental Organizations**

Concerns in the audits of financial statements of governmental organizations related to the diversion of program benefits and/or assets relate primarily to personnel. As discussed previously, employees of governmental organizations are often paid less than market wages. This often results in hiring individuals who do not possess the requisite knowledge, skills, and abilities to effectively perform their assigned tasks. It may also create an *incentive* and/or provide the *rationalization* for the misappropriation of program benefits or assets. The *opportunity* to commit fraud with respect to program benefits and assets is often present due to too few or inadequately trained individuals in administrative or accounting/finance positions.

When the incentive and rationalization to commit fraud with respect to program benefits or assets is coupled with the opportunity for such, fraud may in all likelihood occur. However, in many governmental organizations, employees are subject to prosecution to the full extent of the law if caught performing illegal activities. Obviously the misappropriation of program benefits and assets could be construed as an illegal activity. Therefore, the threat of prosecution may serve as a compensating control in that it might deter someone from committing program fraud, waste, or abuse.

Often employees in small- or medium-size governmental organizations will have other responsibilities in addition to those required of them by the grant program. As such, these employees might be more likely to commit fraud with respect to program benefits or assets as they feel *pressured* to meet unrealistic performance expectations related to all assigned responsibilities. On the other hand, in large governmental organizations, sufficient resources may exist to allow employees to work full time solely within the grant program. This situation may or may not eliminate to potential pressure related to performance expectations.

**Not-for-Profit Organizations**

Like governmental organizations, concerns in the audits of financial statements of not-for-profit organizations also relate to the diversion of program benefits and/or assets due to personnel. Employees of not-for-profit organizations are also often paid less than market wages. As a result individuals who do not possess the requisite knowledge, skills, and abilities to effectively perform their assigned tasks are hired in grant programs. This may create an *incentive* and/or provide the
rationalization for the misappropriation of program benefits or assets. The opportunity to commit fraud with respect to program benefits and assets is often present due to too few or inadequately trained individuals in administrative or accounting/finance positions.

Unlike governmental organizations, employees of not-for-profit organizations may not be subject to prosecution to the full extent of the law if they are caught performing illegal activities. Therefore, the threat of prosecution that may serve as a compensating control in governmental organizations may not exist in not-for-profit organizations.

Like their governmental counterparts, employees in small- or medium-size not-for-profit organizations may have other responsibilities in addition to those required of them by a grant program. As such, these employees might be more likely to commit fraud with respect to program benefits or assets as they feel pressured to meet unrealistic performance expectations related to all assigned responsibilities. In large not-for-profit organizations, sufficient resources may exist to allow employees to work full time solely within the grant program. This situation may or may not eliminate the potential pressure related to performance expectations.

Summary

This chapter focuses on the misappropriation of assets in governmental and not-for-profit organizations. It first discusses the misappropriation of assets with respect to the fraud triangle and then in relation to the fraud process. These discussions concentrate on the specific circumstances in governmental and not-for-profit organizations that may create additional fraud risks for the auditor of these organizations.

Also this chapter identifies five major areas of concern in audits of the financial statements of governmental and not-for-profit organizations. Unique circumstances for each identified area are delineated with respect to governmental and not-for-profit organizations. The major areas of concern related to the misappropriation of assets are

- Procurement and contracting.
- Cash receipts and disbursements.
- Personnel costs.
- Property, plant, and equipment.
- Program benefits and assets.

The use of case studies specific to operations of governmental and not-for-profit organizations reinforces the concepts in the chapter and the auditor’s concerns with respect to the misappropriation of assets in these areas.
Case Examples

Case 5-1 – Misappropriation of Assets in Government Organizations

Directions and Background

Read the following facts about the City of XYZ and answer the questions below in the space provided. The italicized facts represent new information while the regular font information is repeated from Case 4-1.

You are a medium-sized general-purpose firm with 15% of gross revenues coming from audit fees. Firm personnel meeting the qualifications for audits of governmental organizations include one partner, one in-charge accountant, and one staff accountant.

Only one of your current audit clients is a governmental organization and this is the first year your firm has had the audit engagement for the City of XYZ. The contract for the City of XYZ is a three year contract and includes the financial statement audit only as a Yellow Book audit is not required.

Facts

The brainstorming session with all engagement staff during the preliminary audit planning stage reveals the following information:

- The City is a Manager/Council form of government and the current city manager has been in her current position for three years. Prior to that she served as the City’s Human Resources Director for five years. Her employment contract is renewed annually at the discretion of the City Council.

- The terms of the City Manager’s contract state she may be discharged at any time without cause but will receive six-months of salary as severance. If she is fired for cause, she does not receive severance pay. A bonus provision is also included in the contract, payment of which is based on exceeding budgeted General Fund revenues and expending no more than amounts appropriated in the General Fund.

- Four City Council members and the Mayor serve three-year terms and are not subject to term limits. The Mayor is a voting member of the Council and conducts all Council meetings. Tenure of the Council is as follows:
  - Mayor (Running for re-election for a fourth term).
  - Councilman I (In first year of his first term).
  - Councilman II (In first year of her second term).
  - Councilman III (Running for re-election for a third term).
  - Councilman IV (In last year of his second term. Not running for re-election).
During the past 15 years, the City has had four Finance Directors. According to the City Manager, the low pay scale and stringent experience requirements for the position deter many qualified applicants from applying. As a result, underqualified persons have been hired to fill the position but leave within a few years because of the work load and high level responsibilities of the position.

The current Finance Director was hired three months ago, has never held a management position, and this is his first job with a governmental organization. Prior to joining the City, the Finance Director worked for a medium-size CPA firm in a neighboring city for four years.

Due to budget constraints in the current year, all unfilled administrative support functions (including finance) were eliminated. Current Finance Department personnel include, the Finance Director, one accounts payable clerk, one utility billing accountant, and one cashier.

Prior year significant deficiencies included repeat comments related to improper segregation of duties, lack of succession personnel in the finance function, lack of centralized purchasing, and lack of centralized cash receipts. The Council did not address the comments due to a lack of funds.

The City owns and operates a water/sewer utility that rapidly expanded its water distribution and sewer collection systems in the last five years. A new water plant was constructed last year and two additional wells were installed three years ago. Thirty-year revenue bonds were issued to finance the improvements to the water/sewer system. Improvements were made in order to attract residential and commercial development. However, due to a sluggish economy, residential development has been minimal and no commercial development has occurred.

Three years ago, the City contracted its engineering function to two outside professional engineering firms. One firm specializes in water and sewer systems and one firm specializes in transportation. In implementing the requirements of GASB No. 34, estimates of useful lives and assessments of condition were done by these two firms.

Five years ago the City acquired a golf course from a private developer having financial difficulties. This was a controversial issue among the then sitting Council members as well as the community. Due to the volatility of the issue, the Council approving the purchase did so with the explicit direction to City staff that the golf course be always operated at a profit. To accomplish this efficiently, the then Finance Director established an enterprise fund to account for the operations of the golf course.

Two years ago another developer opened a world-class semi-private golf course in an adjacent city. Activity at the City’s golf course has been negatively impacted by this new course and net losses have been incurred in the current year.

The City’s Purchasing Policy requires three bona fide vendor quotes for purchases of goods or services in excess of $5,000 but less than $10,000. Purchase orders are required to be prepared for all goods or services not obtained through a City Purchasing Card. Purchases are initiated at any level and required to be approved by the department head and City Manager before the goods or services are ordered. For purchases in
excess of $5,000, the three quotes are to be attached to the purchase order and the additional approval of the Finance Director is required.

- **In the last month of the fiscal year a $9,900 contract is entered into with a consultant to provide a citizen survey. This same consultant had performed the same services for the City three years ago. No quotes were obtained before the contract was signed by the City Manager. The Finance Director became aware of the contract when the consultant submitted an invoice for his first progress payment.**

- **Certain City employees (primarily supervisors and above) are issued City Procurement Cards for routine purchases. Each card is subject to a maximum per transaction amount, a maximum number of transactions per day and per month, and a maximum amount per month. Controls are programmed into the individual cards and monitored at the point-of-sale. All Procurement Cards are issued through the Finance Department and employees are subject to having their Procurement Card revoked if they are found abusing their cards. If circumstances warrant, employees are also subject to disciplinary actions including termination of employment.**

- **The Supervisor of Water Operations needs to purchase pipe fittings for the repair of a major water line in the Mayor’s neighborhood. Because she is needed on the job site, she gives her Procurement Card to her secretary to order the pipe fittings. When the crisis is over, the Supervisor returns to the office and the secretary returns the Procurement Card to her.**

- **Due to economic conditions, the City has not authorized the hiring of an adequate number of public safety personnel. To maintain proper manpower coverage ratios, it is necessary for fire fighters and police patrol officers to work a significant amount of overtime. Fire fighters work 24-hour shifts followed by 48-hours off while police patrol officers work four 12-hour shifts and then are off for the next three days.**

- **State statutes require the City to annually account for all property, plant, and equipment with an original cost greater than $1,000 and an estimated life of two years or more. The City’s capitalization threshold is $5,000, which is in line with the recommendation of the Government Finance Officers Association. Accordingly, asset identification tags are only placed on assets meeting the capitalization criteria.**

- **An interlocal agreement exists between the City, the County, and the State to distribute rent vouchers to qualified low-income individuals. Under the terms of the agreement, the State sends a quarterly supply of vouchers directly to the City. County personnel process the paperwork for applicants and inform the City of the individuals qualified to receive the rent vouchers. Qualified individuals must take a letter of approval (prepared by the County) to the City in order to receive their rent vouchers for the quarter.**

- **In order to provide benefits to qualifying individuals as soon as possible, the County e-mails the designated City employee whenever individuals are approved for rent vouchers. Monthly, the County sends the designated City employee a list of individuals approved for rent vouchers during the month.**
Questions

1. Based on the facts above, what issues and concerns exist with respect to procurement and contracting? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to assets misappropriated through procurement and/or contracting fraud?

2. Based on the facts above, what issues and concerns exist with respect to cash receipts and disbursements? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to misappropriated cash receipts or misdirected cash disbursements?

3. Based on the facts above, what issues and concerns exist with respect to personnel costs? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to assets misappropriated through fraudulent personnel transactions?

4. Based on the facts above, what issues and concerns exist with respect to property, plant, and equipment? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to misappropriated property, plant, and equipment?

5. Based on the facts above, what issues and concerns exist with respect to diversion of program benefits and/or assets? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to diverted program benefits and/or assets?
Case 5-2 – Misappropriation of Assets in Not-for-Profit Organizations

Directions and Background
Read the following facts about Healthy Families, a large not-for-profit corporation recognized under IRC Section 501(c)(3). Answer the questions below in the space provided. The italicized facts represent new information while the regular font information is repeated from Case 4-2.

You are a small tax and audit firm with 25% of gross revenues coming from audit fees. Firm personnel meeting the qualifications for audits of not-for-profit organizations include one partner and one staff accountant.

Your current audit clients are solely not-for-profit organizations with Healthy Families representing 80% of annual audit fees and 20% of all firm revenues. This is the tenth year your firm has had the audit engagement for Healthy Families. There is no formal audit contract for Healthy Families other than the engagement letter executed each year by the Executive.

Facts
The brainstorming session with all engagement staff during the preliminary audit planning stage reveals the following information:

- The CEO for Healthy Families has been in his position for 10 years and with the organization for 20 years. He was selected to serve as CEO when the previous CEO retired. The ten years prior to being promoted to CEO were spent working up from Program Coordinator, to Branch Manager, and then Vice President of Operations.

- Board positions are filled as needed when current Board members decide to leave the Board. The CEO provides the Executive Committee with the names of potential Board members. After approval by the Executive Committee, potential Board members are formally elected by the Board members at large.

- The Executive Committee is comprised of the CEO, Immediate Past President, President, Vice President, Secretary, and Treasurer. No voting power is vested in the CEO.

- There is no formal audit committee. The Executive Committee acts as both finance and audit committee.

- Healthy Families operates 20 branch locations in a five county area with oversight responsibility performed by a centrally located Administrative Office. Services provided to the Branch offices from the Administrative Office include operational oversight, training, financial accounting and reporting, human resources, marketing, and fundraising.

- Branch operations range from providing minimal services off-site to providing a full range of services both on and off-site. Each branch is operated by a Branch Manager and each branch is staffed with at least one program coordinator and an Office Manager.
• The CEO has created a very competitive performance based environment among the branches. As such, Branch managers and all full-time staff are eligible for annual bonuses based on the extent pre-determined performance goals have been achieved.

• During the past 20 years, Healthy Families has had two Chief Financial Officers. The current CFO was hired by the incumbent CEO not long after he was selected as CEO. According to the CEO, the former CFO was demoted to Accounting Supervisor because he was unable to meet the information demands of the CEO. The former CFO retired from Healthy Families five years ago.

• Administrative Office personnel and Branch Managers are compensated commensurate with prevailing market rates for similar work. Mid-management, office support, and line personnel are paid less than the market, which has resulted in high turnover rates throughout Healthy Families.

• Prior year significant deficiencies included repeat comments related to improper segregation of duties at the branch locations, lack of centralized purchasing, and lack of timely reconciliation of bank statements. The Executive Committee directed the CEO to address the comments as they did not wish to see them repeated. According to the CEO, he has not had time to address the comments, nor does he see a pressing need to address them since they have been repeated every year your firm has performed the audit.

• During your interim field work, Healthy Families received a grant award notice from the State Department of Children and Families. The $1,000,000 grant is for the State’s fiscal year which starts next July 1 and will be on a reimbursement basis.

• Year end for Healthy Families is December 31. Many of the branch program coordinators will be responsible for implementing and running the new grant program. As such, the CEO directed the CFO to record a portion of their current year salaries and benefits as reimbursable by the State as of this December 31.

• In prior years, the CFO has estimated 30% of the pledges receivable on capital campaigns will be uncollectible. This year, the estimate of uncollectible capital campaign pledges receivable has been reduced to 5%. The staff accountant on the audit engagement did not notice the change because the total amount of the subsidiary allowance account was similar to the prior year amount in total.

• All branch personnel are directly involved in the annual fund raising appeal conducted each February. More than half of their time in February is entirely devoted to various aspects of the fund raising campaign. The CFO does not believe it is necessary to classify this time as fund raising expenses, as such activities are inherent in everyone’s job description.

• Each Branch Manager establishes purchasing policies for their branch. The CFO reviews the policies at least annually and must approve any changes to the policies prior to their implementation. The only centrally-administered purchasing functions relate to construction contracts, long-term financing, and banking services. There are no formal written policies. According to the Accounting Manager, the CEO wants to always be in a position to influence potential donors by conducting business with them. As such, he believes formal purchasing policies would restrict his ability to do this.
Misappropriation of Assets

- Each Branch Manager hires and fires all personnel needed to operate the Branch. The Board formally adopted a written Personnel Policy two years ago that included hiring and firing guidelines for Branch Managers. No formal compensation system exists at any level of the organization as the local economic circumstances of the various branch office locations dictate Branch salaries.

- Payroll is processed centrally by Human Resource personnel in the Administrative Office. Personnel file information supplied by the Branch Managers is entered into the payroll management system by the Payroll Clerk. The Payroll Clerk reports to the Human Resources Director who reports to the CEO. Bank statements for the separate payroll account are reconciled by the Accounting Clerk in the Finance Department. The Accounting Clerk reports to the CFO, who reports to the CEO.

- Healthy Families has an organization-wide fixed asset policy which establishes a capitalization threshold for equipment at $2,500 and for buildings and improvements at $100,000. Each Branch Manager is responsible for reporting donated fixed assets to the CFO, who then determines their fair value.

- No asset identification system is used as most capitalized items consist of equipment with serial numbers. Since these assets are included as “scheduled property” on the insurance policy, the CFO feels no asset identification system is necessary. Annual inventories of fixed assets are not considered necessary by the CEO as he believes branch personnel do not have time to focus on such administrative details.

- Personnel at all branch locations are constantly soliciting donations of goods and/or services from local merchants for distribution to program participants. In most cases, merchants provide gift certificates for various goods and services in various amounts. No formal procedures exist related to these types of donations or to the safekeeping of the gift certificates. This practice came to light when your staff accountant mentioned he was going to the movies with his children. He received a family four-pack of movie tickets when his children registered for the spring basketball league at the branch nearest his home.
Questions

1. Based on the facts above, what issues and concerns exist with respect to procurement and contracting? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to assets misappropriated through procurement and/or contracting fraud?

2. Based on the facts above, what issues and concerns exist with respect to cash receipts and disbursements? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to misappropriated cash receipts or misdirected cash disbursements?

3. Based on the facts above, what issues and concerns exist with respect to personnel costs? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to assets misappropriated through fraudulent personnel transactions?

4. Based on the facts above, what issues and concerns exist with respect to property, plant, and equipment? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to misappropriated property, plant, and equipment?

5. Based on the facts above, what issues and concerns exist with respect to diversion of program benefits and/or assets? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to diverted program benefits and/or assets?
Chapter 6

Yellow Book Standards, Audit Committees, and More

Chapter Objectives

After completing this chapter you should be able to

- Realize the differences between reporting under Yellow Book standards and AICPA professional standards.
- Understand guidance in SAS No. 112 related to fraud.
- Recognize steps to prevent, detect, and deter fraud.
- Recognize the valuable and necessary role of the audit committee in the audits of governmental and not-for-profit organizations.

Reporting Under Yellow Book Requirements

Government Auditing Standards

Many governmental and not-for-profit organizations are required to have audits in accordance with government auditing standards. These standards are established by the Government Accountability Office and published as the “Yellow Book.” The standards pertain to an auditor’s

- Ethics.
- Independence.
- Professional competence and judgment.
- Quality control.
- Performance of field work.
- Reporting.

Generally accepted government auditing standards (GAGAS) are followed by auditors when they are required to do so by

- Law.
- Regulation.
Independence

In an effort to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities the Government Accountability Office has established independence standards for governmental auditors. These GAO independence standards exceed those of the AICPA in certain circumstances especially as they relate to non audit, or consulting services. CPAs performing audits of governmental and not-for-profit organizations under Yellow Book requirements should be familiar with these independence standards.

Government Auditing Standards and AICPA Professional Standards

GAGAS are used in conjunction with AICPA professional standards for audits of governmental and not-for-profit organizations performed by certified public accountants. As such, GAGAS incorporate AICPA field work and reporting standards and the related statements on auditing standards for financial statement audits except where specifically excluded. GAGAS also incorporate the AICPA general standard on criteria, the field work, and reporting standards as well as related statements on standards for attestation engagements unless specifically excluded.

However, GAGAS prescribe requirements in addition to those provided by the AICPA. This is of special interest to the auditor of governmental and not-for-profit organizations with respect to the consideration of fraud in the audits of the financial statements of these organizations.

The auditor must comply with these additional standards when citing GAGAS in their audit reports. GAGAS include general standards relating to independence, professional judgment, competence (including CPE), and quality control and assurance (including peer review). Additional GAGAS standards relate to the following areas:

- Field Work Standards – Financial Audits
  - Auditor communication – Broadens parties with whom auditors must communicate and requires communication of specific information.
  - Consideration of the results of previous audits and attestation engagements – Identify concerns with respect to the current audit and ascertain corrective action taken.
  - Detecting material misstatements resulting from violations of contract provisions or grant agreements, or from abuse.
  - Developing elements of a finding.
  - Audit documentation.
- Reporting Standards – Financial Audits
  - Auditor’s compliance with GAGAS.
– Internal control and compliance with laws, regulations, and provisions of contracts or grant agreements.
– Deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse.
– Emphasizing significant matters in the auditors’ report.
– Reporting on restatement of previously issued financial statements.
– Reporting views of responsible officials.
– Reporting confidential or sensitive information.
– Report distribution.

• Field Work Standards – Attestation Engagements
  – Auditor communication – Information about the nature, timing, and extent of planned testing and reporting.
  – Consideration of the results of previous audits and attestation engagements – Identify concerns with respect to the current audit and ascertain corrective action taken.
  – Internal control – Obtain understanding with respect to the subject matter or assertion being tested.
  – Fraud, illegal acts, violations of contract provisions or grant agreements, or abuse that could have a material effect on the subject matter.
  – Developing elements of findings for attestation engagements.
  – Attest documentation.

• Reporting Standards – Attestation Engagements
  – Auditor’s compliance with GAGAS.
  – Reporting deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse.
  – Views of responsible officials.
  – Reporting confidential or sensitive information.
  – Report distribution.

• Field Work and Reporting Standards for Performance Audits

Auditing for Abuse

According to the Yellow Book, abuse is not the same as fraud, illegal acts, or violations of contract provisions or grant agreements. As defined by Section 4.12 of the Yellow Book:
“...abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances.”

When the auditor obtains information indicating abuse might have occurred he/she should consider whether such possible abuse could significantly affect the financial statement amounts or other data. The auditor should consider such instances of potential abuse from both a qualitative and quantitative perspective. Auditors are not expected under Yellow Book standards to provide reasonable assurance of detecting abuse because such determination is subjective.

In a Yellow Book financial statement audit, common areas where instances of abuse might occur include

- **Travel expenditures/expenses** – First class airfare, meeting locations chosen for personal reasons rather than less costly locations, driving a personal vehicle and being reimbursed for mileage when less expensive transportation alternatives, exist, etc.

- **Excessive and/or personal use of cellular phones** – Calls to a facility placed soon after leaving it, calls made of a personal nature or during business hours, etc.

- **Personal use of assets** owned by the governmental or not-for-profit organization – Use of organization owned vehicles for personal errands, maintenance of personal files on computers owned by the organization, etc.

Obviously, these types of expenditures/expenses are not usually material to the financial statements from a quantitative perspective. However, if abuse is identified, it could be qualitatively material to the financial statements.

**Where Can I Find More Information?**

Auditors performing audits of governmental and not-for-profit organizations should be familiar with government auditing standards. Additionally, these auditors should be aware of the distinctions between government auditing standards and auditing standards of the AICPA. The Yellow Book is available at www.gao.gov. Excerpts from the Yellow Book are presented in Appendix A.

**SAS No. 115 and Fraud**

In October 2008, the AICPA issued SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit*. SAS No. 115 replaces the predecessor SAS No. 112 and is effective for audits of financial statements for periods ending on or after December 15, 2009. SAS No. 115 contains a few discussions relating to fraud including the following:

- SAS No. 115 discusses that in an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control or to express an opinion on the effectiveness of the entity’s internal control. However, during the course of an audit, the auditor may become aware of deficiencies in internal control while obtaining an understanding of the entity and its environment, including its internal control, assessing the risks of material misstatement of the financial statements due to error or fraud,
performing further audit procedures to respond to assessed risks, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise.

- Included in a listing of risk factors that affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure is “the susceptibility of the related asset or liability to loss or fraud.”

- SAS No. 115 contains a listing of indicators of material weaknesses in internal control. Among this listing are the following:
  - Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud.
  - Identification of fraud, whether or not material, on the part of senior management.

- An exhibit to SAS No. 115 contains a listing of examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses. This listing includes “misrepresentation by entity personnel to the auditor (an indicator of fraud).”

**How to Prevent, Detect, and Deter Fraud – Almost!**

Being aware of situations that have the potential to create fraud risks is the first step in designing effective programs and controls to prevent, detect, and deter fraud. The following general situations may be warning signs indicating fraudulent financial reporting and/or fraud due to misappropriation of assets:

- An organizational culture of arrogance and management entitlement.
- Accounting policies relying too heavily on management’s judgment.
- Accounting policies that seem too aggressive especially in light of accounting and finance staff expertise.
- Overly centralized control over financial reporting especially in organizations with larger or more adequate staff in the areas of accounting and finance.
- Departure of key senior management personnel.
- Failure to listen to key accounting/finance personnel within the organization.
- Receivables growing at a faster rate than the related revenues.
- Periods of prolonged success especially when economic, industry, or organizational conditions indicate otherwise.
- Difficulty in paying bills on a timely basis or less timely than in prior years.
- Transactions lack economic purpose (may be indicative of kickbacks as well as misappropriation of assets or financial statement fraud).
Assets are commonly misappropriated through embezzlement meaning money is taken before or after it is deposited in the organization’s bank account. When money is taken before it is deposited, the embezzler must also adjust customer accounts to conceal the embezzlement. Usually embezzlement starts with small amounts and increases to large amounts over time until it is discovered.

Knowledge of the “typical embezzler” is helpful in detecting fraud from misappropriation of assets. When the stress of embezzlement catches up to an embezzler (or when they feel they are about to be caught), their personalities often change and they may become moody. Characteristics of the “typical embezzler” include:

- Trusted employee.
- Dedicated and often works long hours.
- Dislikes mandatory vacation policies.
- Resents cross training.
- Seen as likeable and generous.
- Deceptive and usually an adept liar.

A number of low cost, high impact policies and procedures can be implemented to help prevent, detect, and deter fraud in most governmental and not-for-profit organizations. A highly effective and almost no-cost control that can be implemented by any governmental or not-for-profit organization is to take a hard line with respect to fraud. If the “tone at the top” is one of zero tolerance and/or if fraudsters are promptly disciplined, employees may be less likely to commit fraud. A positive and open work environment, at all levels of the organization, also helps in preventing, detecting, and deterring fraud.

Other general techniques to prevent, detect, or deter fraud include:

- **General**
  - Periodic review of control accounts for adjustments when fully integrated subsidiary systems are in place.
  - Establishment of a “fraud hotline” (as simple as a board member with a cell phone or as sophisticated as a separate phone line allowing anonymous calls 24/7).
- **Cash**
  - Timely reconciliation of bank statements reviewing statements for:
    - Unusual activity;
    - Dual endorsements on back of checks;
    - Changes to items of front of checks; and,
    - Individuals endorsing checks issued to a business.
• **Purchasing/accounts payable**
  – Extensive paperwork and procedures related to setting up new vendors (especially effective if purchasing is extremely decentralized).
  – When controls and programs related to cash disbursements/purchasing are inadequate, use a simple software program (internally developed or purchased off the shelf) to:
    - Cross-reference vendor names to all permutations of employee names;
    - Cross-reference vendor payment addresses to all employee addresses;
    - Cross-reference all delivery locations on vendor statements to all physical addresses of the organization;
    - Cross-reference phone numbers on vendor statements to employee phone numbers;
    - Cross-reference all delivery locations on vendor statements to all employee addresses;
    - Identify vendors with higher than expected purchase volume either for the month or for the year (or some other meaningful period);
    - Identify transactions (purchases, purchase orders, and checks) falling just below established threshold amounts listed by vendor, purchaser, department/agency, employee, etc.;
    - List vendors with incomplete master file information; and,
    - List vendors added and deleted within an established time frame.

• **Payroll/personnel**
  – Mandatory background checks prior to starting work.
  – Printing accrued and unused leave hours on employee pay check stubs (deters theft of hours when payroll/personnel controls are inadequate).
  – Surprise visits to offsite locations.

**Procurement Cards**

Increased use of procurement or purchasing cards may result in increased fraud risks if adequate controls over their use and distribution are not in place. Financial institutions offering procurement card systems are able to put a number of effective controls in place related primarily to spending limits and vendor types. These financial institution controls typically include:

• Single purchase limits;
• Weekly or monthly purchase limits;
• Blocking or limiting cash options; and,
• Merchant category blocking.

In addition to the controls available through the financial institution, the governmental or not-for-profit organization can implement other controls over procurement cards. Fraud due to misappropriation of assets using a procurement card may be prevented, detected, or deterred using the following controls:

• Prohibiting the use of procurement cards for the purchase of gift cards.
• Blocking the cash option on all procurement cards.
• Written policies and procedures related to the issuance and use of procurement cards.
• Requiring employees with procurement cards to execute a “cardholder’s agreement” prior to receiving their procurement card. This agreement should specifically state the employee’s responsibilities with respect to use of the card and the consequences if the procurement card is used fraudulently.
• Submission of receipts with card statements and review of these receipts by a responsible and appropriate party (i.e. supervisor, administrative support staff, accounts payable staff, etc.).
• Prompt processing of card statements at the user level (i.e. within x days of receipt) and timely forwarding of same for payment.
• Review of periodic “exception reports” whether developed internally or by the financial institution.
• Random audits of procurement card purchases by the internal audit or finance department.

**Computer Fraud**

In today’s business environment, technology plays a major role in almost all aspects of an organization’s operations. The CPA or CFO may be unable to keep up with technological changes. In many of these cases, the establishment of programs and controls to prevent, detect, or deter computer-related fraud is left to the technology function. By understanding the factors that encourage fraud, effective programs and controls that discourage fraud can be developed.

Factors influencing computer crime are either motivational or personal. Motivational and personal factors relate to both rationalization/attitude and incentive/pressure in the fraud triangle. The following motivational and personal factors tend to encourage computer crime:

• Inadequate pay and benefits including promotional opportunities.
• Poor communication of expectations (job performance, behavior, etc.) by management.
• Lack of performance feedback mechanisms.
• Mediocre performance is an acceptable performance standard.
• Inadequate support and lack of resources to meet standards.
• Not enough review and follow-up to assure compliance with organizational programs and controls.
• Inadequate standards of recruitment and selection.
• Deficient or missing orientation and training programs.

Preventing computer fraud is not necessarily a highly technical and/or expensive proposition. The primary factors that discourage computer crime are:

• Internal accounting controls.
• Access controls.
• Internet firewalls.

Internal accounting controls that may be effective in preventing, detecting, and deterring computer fraud include the following:

• Separation and rotation of duties both within and external to the technology function.
• Timely update of accessible computer applications when personnel change jobs or when the requirements of their current position change.
• Periodic and surprise inspections and security reviews.
• All control policies and procedures required to be written (zero tolerance for deviations from this policy).
• Offline controls and limits such as batch controls and hash totals where indicated and cost effective.

Access controls to prevent, detect, and deter computer fraud include the following:

• Authentication/identification controls such as:
  – Keys
  – Smartcards
  – Passwords
  – Biometrics
  – Callback systems
  – One-time passwords
  – Constrained access by time and day
  – Periodic code and password changes
• Compartmentalization of information.
• Encryption of data while stored or in transit.
The Role of the Audit Committee

Overview

An audit committee can play a vital role for any organization, but especially for governmental and not-for-profit organizations where accountability to the public and to resource providers is paramount. If organized properly and allowed to function with autonomy, an audit committee can be an effective control, as well as a liaison between management, the external auditor, internal auditors, and the governing body or board of directors.

Governmental and not-for-profit organizations may or may not have a formal audit committee function. In lieu of a formal audit committee function, the governing body of a governmental organization may serve in an audit committee capacity. Likewise, the board of directors or finance committee may serve an audit committee function in not-for-profit organizations. Regardless of the form of the audit committee function, the auditor should thoroughly understand the substance, authority, capacity, and role of the de facto audit committee.

Citizens, stakeholders, resource providers, and the financial community have an ever-increasing expectation with respect to the oversight role of the audit committee. In some cases, it may be necessary for the auditor to educate and/or advise members of the formal or de facto audit committee for them to better execute their oversight responsibilities.

Duties of an Audit Committee

In governmental and not-for-profit organizations, audit committees can assist the governing body or board of directors, respectively, in understanding financial matters. This will result in a more knowledgeable board and will also augment the external audit function. An audit committee should be large enough to incorporate business and financial diversity yet small enough to be manageable. In carrying out their duties, members of an audit committee should be

- Objective.
- Competent.
- Aggressive.

The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees was formed in the fall of 1998 by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). In early 1999, this committee issued a 71-page report with 10 recommendations serving as the foundation to strengthen the independence and effectiveness of the audit committee. Briefly, the 10 cornerstone recommendations were as follows:

1. Adoption by the NYSE and NASD of stricter definitions of independence for directors serving on audit committees of listed companies.

2. Requirement by the NYSE and NASD for larger companies to have audit committees composed entirely of independent directors.
3. Requirement by the NYSE and NASD for larger companies to have “financially literate” directors on their audit committees.

4. Requirement by the NYSE and NASD that each company adopt a formal audit committee charter and to review it at least annually for adequacy.

5. Recommendation that each company disclose whether it has adopted an audit committee charter, as well as other information, in its proxy statement.

6. For listed NYSE and NASD companies a statement in the audit committee charter that the outside auditor is ultimately accountable to the board of directors and the audit committee.

7. Charter mandated communication between audit committees and outside auditors of listed NYSE and NASD companies about independence issues (in accordance with ISB regulations).

8. Recommend that generally accepted auditing standards require discussions between the outside auditor and the audit committee as to the quality of accounting principles used rather than simply the acceptability of such issues.

9. Recommend that each company include in its annual report a letter from the audit committee clarifying it has reviewed the audited financial statements with management as well as performed other tasks.

10. Recommend that the outside auditor perform an interim review under SAS No. 71, Interim Financial Information, before a company files its form 10-Q.

Clearly, had the recommendations of the Blue Ribbon Committee been in effect, the financial machinations of Enron, Global Crossing, and WorldCom might have been detected in time to avoid financial collapse or avoided completely. The “public” aspect of governmental and not-for-profit organizations is not too much different than that of publicly traded companies.

Therefore, some of the recommendations of the Blue Ribbon Committee may be very applicable to these “public” organizations.

Today, the first and foremost responsibility of the audit committee should be to safeguard the overall objectivity of the financial reporting and internal control processes. To that end, typical duties of an effective audit committee should include:

- Choosing the independent auditor.
- Reviewing the audit.
- Considering the report on internal control weaknesses.
- Reviewing the work of the internal audit function.
- Reviewing year-end and interim financial statements.
• Reviewing and approving *changes in accounting principles*.

• Considering and evaluating *non-audit services* performed by the external auditor.

• Preparing *reports to the governing body or board of directors* of all actions and recommendations taken by the audit committee.

Provisions of the Sarbanes-Oxley Act apply only to those companies that are publicly traded. However, some of the requirements of audit committees of these companies imposed by Sarbanes-Oxley are relevant to audit committees of governmental and not-for-profit organizations. For governmental organizations, state statutes, enabling legislation, or other legal or charter provisions may preclude the audit committee from certain of these responsibilities. Responsibilities of the audit committee under provisions of Sarbanes-Oxley relevant to governmental and not-for-profit organizations include

• Direct responsibility for the *appointment, compensation, retention, and oversight of independent auditors* reporting directly to the audit committee.

• Establishing specific *procedures for handling complaints* received by the organization related to accounting, internal accounting controls, or audit matters.

• *Pre-approve all audit services and permitted non-audit services* provided by outside accounting firms (subject to a narrow *de minimis* exception).

• Timely receipt of the following *reports required of the external auditor*:
  
  - Critical *accounting policies and practices* to be used.
  
  - *Alternative treatments of financial information* within generally accepted accounting principles discussed with management including the following:
    
    ▪ *Ramifications of the use* of such alternative disclosures and treatments.
    
    ▪ *Treatment preferred* by the external audit firm.
  
  - *Other material*, including, but not limited to, the following:
    
    ▪ Written communication between the external audit firm and management regarding certain issues.
    
    ▪ Any *management letter or schedule*.
    
    ▪ *Unadjusted differences*.

**Implementing an Effective Audit Committee**

Internal control over financial reporting has always been significant in the governance of an organization. An audit committee function may be extremely effective in discharging part of the responsibility governmental and not-for-profit organizations have for compliance and public accountability.

A number of resources are available to governmental and not-for-profit organizations and their auditor wishing to implement or improve an audit committee function. The AICPA has created
an Audit Committee Effectiveness Center where information, resources, toolkits (available for download) publications, and related links are available to assist in this process. Such information is available through the home page of the AICPA at www.aicpa.org or directly through the Audit Committee Effectiveness Center at www.aicpa.org/audcommctr.

Summary

This chapter discusses the requirements of the auditor of governmental and not-for-profit organizations with respect to audits performed under generally accepted government auditing standards. The differences in audit standards under requirements of the Yellow Book and those promulgated by the AICPA are outlined in this chapter also.

Also this chapter talks about the role of the audit committee in financial statement audits of governmental and not-for-profit organizations. The duties of an audit committee are delineated in light of the Sarbanes-Oxley Act and the 1998 SEC Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. Resources available to CPAs from the AICPA with respect to implementing an audit committee function are also included in the chapter.
Review Questions

1. When is an auditor required to follow GAGAS?

2. What is the definition of “abuse” provided in the Yellow Book?

3. List the common areas for abuse in governmental and/or not-for-profit organizations.

4. What are typical duties of an audit committee?
Appendix A

Government Auditing Standards Excerpts*

* Obtained from www.gao.gov
This chapter establishes field work standards and provides guidance for financial audits conducted in accordance with generally accepted government auditing standards (GAGAS). This chapter identifies the American Institute of Certified Public Accountants (AICPA) field work standards and prescribes additional standards for financial audits performed in accordance with GAGAS.

For financial audits, GAGAS incorporate the AICPA field work and reporting standards and the related statements on auditing standards (SAS) unless specifically excluded or modified by GAGAS.

Under AICPA standards and GAGAS, auditors must plan and perform the audit to obtain sufficient appropriate audit evidence so that audit risk will be limited to a low level that is, in their professional judgment, appropriate for expressing an opinion on the financial statements. The high, but not absolute, level of assurance that is intended to be obtained by auditors is expressed in the auditor’s report as obtaining reasonable assurance about whether the financial statements are free of material misstatement (whether caused by error or fraud). Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.

For financial audits performed in accordance with GAGAS, chapters 1 through 5 apply.

To date, the Comptroller General has not excluded any field work standards or SAS.
Chapter 4
Field Work Standards for Financial Audits

AICPA Field Work Standards

4.03 The three AICPA generally accepted standards of field work are as follows:47

a. The auditor must adequately plan the work and must properly supervise any assistants.

b. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

c. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Additional Government Auditing Standards

4.04 GAGAS establish field work standards for financial audits in addition to the requirements contained in the AICPA standards. Auditors should comply with these additional standards when citing GAGAS in their audit reports. The additional government auditing standards relate to:

a. auditor communication during planning (see paragraphs 4.05 through 4.08);

b. previous audits and attestation engagements (see paragraph 4.09);

c. detecting material misstatements resulting from violations of provisions of contracts or grant

47See AU Section 150, Generally Accepted Auditing Standards.
agreements, or from abuse (see paragraphs 4.10 through 4.13); 

d. developing elements of a finding (see paragraphs 4.14 through 4.18); and 

e. audit documentation (see paragraphs 4.19 through 4.24). 

4.05 Under AICPA standards and GAGAS, auditors should communicate with the audited entity their understanding of the services to be performed for each engagement and document that understanding through a written communication. GAGAS broaden the parties included in the communication and the items for the auditors to communicate.

4.06 Under GAGAS, when planning the audit, auditors should communicate certain information in writing to management of the audited entity, those charged with governance, and to the individuals contracting for or requesting the audit. When auditors perform the audit pursuant to a law or regulation or they conduct the work for the legislative committee that has oversight of the audited entity, auditors should communicate with the legislative committee. In those situations where there is not a single individual or group that both oversees the strategic direction of the entity and the fulfillment of its accountability obligations or in other situations where the identity of those charged with governance is not clearly evident, auditors should document the process

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48See AICPA Statement on Auditing Standard No. 108, Planning and Supervision.

49Those charged with governance are those responsible for overseeing the strategic direction of the entity and the entity’s fulfillment of its obligations related to the accountability of the entity. (See appendix I, paragraphs A1.05 through A1.07 for additional information.)
followed and conclusions reached for identifying the appropriate individuals to receive the required auditor communications. Auditors should communicate the following additional information under GAGAS:

a. The nature of planned work and level of assurance to be provided related to internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements.

b. Any potential restriction on the auditors’ reports, in order to reduce the risk that the needs or expectations of the parties involved may be misinterpreted.

4.07 Under AICPA standards and GAGAS, tests of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements in a financial statement audit contribute to the evidence supporting the auditors’ opinion on the financial statements or other conclusions regarding financial data. However, such tests generally are not sufficient in scope to provide an opinion on the effectiveness of internal control over financial reporting or compliance with laws, regulations, and provisions of contracts or grant agreements. To meet the needs of certain audit report users, laws and regulations sometimes prescribe supplemental testing and reporting on internal control over financial reporting and
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compliance with laws, regulations, and provisions of contracts and grant agreements.\(^{50}\)

4.08 If an audit is terminated before it is completed and an audit report is not issued, auditors should document the results of the work to the date of termination and why the audit was terminated. Determining whether and how to communicate the reason for terminating the audit to those charged with governance, appropriate officials of the audited entity, the entity contracting for or requesting the audit, and other appropriate officials will depend on the facts and circumstances and, therefore, is a matter of professional judgment.

Previous Audits and Attestation Engagements

4.09 Auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements. When planning the audit, auditors should ask management of the audited entity to identify previous audits, attestation engagements, and other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented. Auditors should use this information in assessing risk and determining the nature, timing, and extent of current audit work, including determining the extent to which testing the implementation of the

\(^{50}\)For example, when engaged to perform audits under the Single Audit Act, as amended, for state and local government entities and nonprofit entities that receive federal awards, auditors follow Office of Management and Budget (OMB) Circular No. A-133. The act and circular include specific audit requirements, mainly in the areas of compliance with laws and regulations and internal control over compliance that go beyond the requirements in chapters 4 and 5 of GAGAS. Audits performed pursuant to the Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994 and the Accountability of Tax Dollars Act of 2002, also have specific audit requirements prescribed by OMB in the areas of internal control and compliance. In addition, some state and local governments may have additional audit requirements that the auditors would need to follow in planning the audit.
4.10 Auditors should design the audit to provide reasonable assurance of detecting misstatements that result from violations of provisions of contracts or grant agreements and could have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.

4.11 If specific information comes to the auditors’ attention that provides evidence concerning the existence of possible violations of provisions of contracts or grant agreements that could have a material indirect effect on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether such violations have occurred. When the auditors conclude that a violation of provisions of contracts or grant agreements has or is likely to have occurred, they should determine the effect on the financial statements as well as the implications for other aspects of the audit.

4.12 Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. Abuse does not necessarily involve fraud, violation of laws, regulations, or provisions of a contract or grant agreement.

4.13 If during the course of the audit, auditors become aware of abuse that could be quantitatively or qualitatively material to the financial statements, auditors should apply audit procedures specifically
directed to ascertain the potential effect on the financial statements or other financial data significant to the audit objectives. After performing additional work, auditors may discover that the abuse represents potential fraud or illegal acts. Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse.

**Developing Elements of a Finding**

4.14 Audit findings may involve deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse. The elements needed for a finding depend entirely on the objectives of the audit. Thus, a finding or set of findings is complete to the extent that the audit objectives are satisfied. When auditors identify deficiencies, auditors should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. The elements of an audit finding are discussed in paragraphs 4.15 through 4.18.

4.15 Criteria: The laws, regulations, contracts, grant agreements, standards, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated. Criteria identify the required or desired state or expectation with respect to the program or operation. Criteria provide a context for evaluating evidence and understanding the findings.

4.16 Condition: Condition is a situation that exists. The condition is determined and documented during the audit.

4.17 Cause: The cause identifies the reason or explanation for the condition or the factor or factors responsible for the difference between the situation that exists (condition) and the required or desired state (criteria), which may also serve as a basis for
recommendations for corrective actions. Common factors include poorly designed policies, procedures, or criteria; inconsistent, incomplete, or incorrect implementation; or factors beyond the control of program management. Auditors may assess whether the evidence provides a reasonable and convincing argument for why the stated cause is the key factor or factors contributing to the difference.

4.18 Effect or potential effect: The effect is a clear, logical link to establish the impact or potential impact of the difference between the situation that exists (condition) and the required or desired state (criteria). The effect or potential effect identifies the outcomes or consequences of the condition. When the audit objectives include identifying the actual or potential consequences of a condition that varies (either positively or negatively) from the criteria identified in the audit, “effect” is a measure of those consequences. Effect or potential effect may be used to demonstrate the need for corrective action in response to identified problems or relevant risks.

4.19 Under AICPA standards and GAGAS, auditors must prepare audit documentation in connection with each audit in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. Under AICPA standards and GAGAS, auditors should prepare audit documentation in connection with each audit in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.
that enables an experienced auditor,\textsuperscript{52} having no previous connection to the audit, to understand

\begin{itemize}
\item[a.] the nature, timing, and extent of auditing procedures performed to comply with GAGAS and other applicable standards and requirements;
\item[b.] the results of the audit procedures performed and the audit evidence obtained;
\item[c.] the conclusions reached on significant matters; and
\item[d.] that the accounting records agree or reconcile with the audited financial statements or other audited information.
\end{itemize}

\textbf{4.20} Under GAGAS, auditors also should document, before the audit report is issued, evidence of supervisory review of the work performed that supports findings, conclusions, and recommendations contained in the audit report.

\textbf{4.21} When auditors do not comply with applicable GAGAS requirements due to law, regulation, scope limitations, restrictions on access to records, or other issues impacting the audit, the auditors should document the departure from the GAGAS requirements and the impact on the audit and on the auditors’ conclusions. This applies to departures from both mandatory requirements and presumptively mandatory requirements where alternative procedures performed

\textsuperscript{52}An experienced auditor means an individual (whether internal or external to the audit organization) who possesses the competencies and skills that would have enabled him or her to perform the audit. These competencies and skills include an understanding of (1) audit processes, (2) GAGAS and applicable legal and regulatory requirements, (3) the environment in which the entity operates, and (4) auditing and financial reporting issues relevant to the audited entity’s environment.
in the circumstances were not sufficient to achieve the objectives of the standard. (See paragraphs 1.12 and 1.13.)

4.22 Audit organizations should establish policies and procedures for the safe custody and retention of audit documentation for a time sufficient to satisfy legal, regulatory, and administrative requirements for record 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 establish information systems controls concerning accessing and updating the audit documentation.

4.23 Underlying GAGAS audits is the premise that audit organizations in federal, state, and local governments and public accounting firms engaged to perform a financial audit in accordance with GAGAS cooperate in auditing programs of common interest so that auditors may use others’ work and avoid duplication of efforts. Subject to applicable laws and regulations, auditors should make appropriate individuals, as well as audit documentation, available upon request and in a timely manner to other auditors or reviewers to satisfy these objectives. The use of auditors’ work by other auditors may be facilitated by contractual arrangements for GAGAS audits that provide for full and timely access to appropriate individuals, as well as audit documentation.

4.24 Audit organizations should develop policies to deal with requests by outside parties to obtain access to audit documentation, especially when an outside party attempts to obtain information indirectly through the auditor rather than directly from the audited entity. In
developing such policies, audit organizations should determine what laws and regulations apply, if any.

**Additional Considerations for GAGAS Financial Audits**

4.25 Due to the audit objectives and public accountability of GAGAS audits, there may be additional considerations for financial audits completed in accordance with GAGAS. These considerations relate to

a. materiality in GAGAS financial audits (see paragraph 4.26);

b. consideration of fraud and illegal acts (see paragraphs 4.27 and 4.28); and

c. ongoing investigations or legal proceedings (see paragraph 4.29).

**Materiality in GAGAS Financial Audits**

4.26 Under both AICPA standards and GAGAS, the auditors’ responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected.53 The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important. In performing the audit, matters that, either individually or in the aggregate, could be material to the financial statements are a primary consideration.54 Additional considerations may apply to GAGAS financial audits of government entities or entities that receive government

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53See AU Section 110, *Responsibilities and Functions of the Independent Auditor*.

54See AICPA Statement on Auditing Standards No. 107, *Audit Risk and Materiality in Conducting an Audit*.
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awards. For example, in audits performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.55

Consideration of Fraud and Illegal Acts

4.27 Under both the AICPA standards56 and GAGAS, auditors should plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.57 Recognizing the possibility that a material misstatement due to fraud could be present is important for achieving this objective. However, absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud.

55In accordance with AICPA Statement on Auditing Standards No. 107, Audit Risk and Materiality in Conducting an Audit, the auditor’s consideration of materiality is a matter of professional judgment and is influenced by the auditor’s perception of the needs of users of financial statements. The Financial Accounting Standards Board defined materiality in its Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information as “the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.”

56See AU Section 316, Consideration of Fraud in a Financial Statement Audit.

57Two types of misstatements are relevant to the auditors’ consideration of fraud in an audit of financial statements–misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional.
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Field Work Standards for Financial Audits

4.28 Under both the AICPA standards and GAGAS, auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from illegal acts that could have a direct and material effect on the financial statements. If specific information comes to the auditors' attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditors should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. When an illegal act has or is likely to have occurred, auditors should determine the effect on the financial statements as well as the implications for other aspects of the audit.

4.29 Avoiding interference with investigations or legal proceedings is important in pursuing indications of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse. Laws, regulations, or policies might require auditors to report indications of certain types of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse to law enforcement or investigatory authorities before performing additional audit procedures. When investigations or legal proceedings are initiated or in

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58See AU Sections 317.02, 317.05, and 316.01 for AICPA standards and guidance related to auditors’ responsibilities when a possible illegal act is detected.

59Illegal acts are violations of laws or government regulations that have a direct and material effect on the determination of financial statement amounts. For example, applicable laws and regulations may affect the amount of revenue accrued under government contracts. However, the auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

60Whether a particular act is, in fact, illegal may have to await final determination by a court of law or other adjudicative body. Disclosing matters that have led auditors to conclude that an illegal act is likely to have occurred is not a final determination of illegality.
process, auditors should evaluate the impact on the current audit. In some cases, it may be appropriate for the auditors to work with investigators and/or legal authorities, or withdraw from or defer further work on the audit engagement or a portion of the engagement to avoid interfering with an investigation.
Chapter 5

Reporting Standards for Financial Audits

Introduction

5.01 This chapter establishes reporting standards and provides guidance for financial audits conducted in accordance with generally accepted government auditing standards (GAGAS). For financial audits, GAGAS incorporate the American Institute of Certified Public Accountants (AICPA) field work and reporting standards and the related statements on auditing standards (SAS) unless specifically excluded or modified by GAGAS. 61 This chapter identifies the AICPA reporting standards and prescribes additional standards for financial audits performed in accordance with GAGAS.

5.02 For financial audits performed in accordance with GAGAS, chapters 1 through 5 apply.

AICPA Reporting Standards

5.03 The four AICPA generally accepted standards of reporting 62 are as follows:

a. The auditor must state in the auditor’s report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).

b. The auditor must identify in the auditor’s report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

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61To date, the Comptroller General has not excluded any reporting standards or SAS.

62See AU Section 150, Generally Accepted Auditing Standards. Under AU Section 150, when an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP, the first standard of reporting is satisfied by stating in the auditor’s report that the basis of presentation is a comprehensive basis of accounting other than GAAP and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used.
c. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

d. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking in the auditor's report.

5.04 GAGAS establish reporting standards for financial audits in addition to the standards contained in the AICPA standards. Auditors should comply with these additional standards when citing GAGAS in their audit reports. The additional government auditing standards relate to

a. reporting auditors’ compliance with GAGAS (see paragraphs 5.05 and 5.06);

b. reporting on internal control and compliance with laws, regulations, and provisions of contracts or grant agreements (see paragraphs 5.07 through 5.09);

c. reporting deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse (see paragraphs 5.10 through 5.22);

d. communicating significant matters in the auditors’ report (see paragraphs 5.23 through 5.25);
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e. reporting on the restatement of previously-issued financial statements (see paragraphs 5.26 through 5.31);

f. reporting views of responsible officials (see paragraphs 5.32 through 5.38);

g. reporting confidential or sensitive information (see paragraphs 5.39 through 5.43); and

h. distributing reports (see paragraph 5.44).

Reporting Auditors’ Compliance with GAGAS

5.05 When auditors comply with all applicable GAGAS requirements, they should include a statement in the auditors’ report that they performed the audit in accordance with GAGAS. (See paragraphs 1.12 and 1.13 for additional requirements on citing compliance with GAGAS.)

5.06 An audited entity receiving a GAGAS audit report may also request auditors to issue a financial audit report for purposes other than complying with requirements for a GAGAS audit. For example, the audited entity may need audited financial statements to issue bonds or for other financing purposes. GAGAS do not prohibit auditors from issuing a separate report conforming only to AICPA or other standards.

Reporting on Internal Control and Compliance with Laws, Regulations, and Provisions of Contracts or Grant Agreements

5.07 When providing an opinion or a disclaimer on financial statements, auditors must also report on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements.

5.08 Auditors should include either in the same or in separate report(s) a description of the scope of the auditors’ testing of internal control over financial reporting and compliance with laws, regulations, and
provisions of contracts or grant agreements. If the auditors issue separate reports, they should include a reference to the separate reports in the report on financial statements. Auditors should state in the reports whether the tests they performed provided sufficient, appropriate evidence to support an opinion on the effectiveness of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements. The internal control reporting standard under GAGAS differs from the objective of an examination of internal control in accordance with the AICPA Statement on Standards for Attestation Engagements (SSAE), which is to express an opinion on the design or the design and operating effectiveness of an entity’s internal control, as applicable. To form a basis for expressing such an opinion, the auditor must plan and perform the examination to obtain reasonable assurance about whether the entity maintained, in all material respects, effective internal control as of a point in time or for a specified period of time.

5.09 When auditors report separately (including separate reports bound in the same document) on internal control over financial reporting and compliance with laws and regulations and provisions of contracts or grant agreements, they should state in the financial statement audit report that they are issuing those additional reports. They should include a reference to the separate reports and also state that the reports on internal control over financial reporting and compliance with laws and regulations and provisions of contracts or grant agreements are an integral part of a GAGAS audit and important for assessing the results of the audit. If auditors issued or intend to issue a management letter,

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63This requirement applies to financial statement audits described in paragraph 1.22a. It does not apply to other types of financial audits described in paragraph 1.22b.
they should refer to that management letter in the reports.

5.10 For financial audits, including audits of financial statements in which auditors provide an opinion or disclaimer, auditors should report, as applicable to the objectives of the audit, and based upon the audit work performed, (1) significant deficiencies in internal control, identifying those considered to be material weaknesses; (2) all instances of fraud and illegal acts unless inconsequential; and (3) violations of provisions of contracts or grant agreements and abuse that could have a material effect on the financial statements.\(^64\)

5.11 For all financial audits, auditors should report the following deficiencies in internal control:

a. **Significant deficiency**: a deficiency in internal control, or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with GAAP such that there is more than a remote\(^65\) likelihood that a misstatement of the entity's financial statements that is

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\(^64\)If the auditor is performing an audit in accordance with Office of Management and Budget (OMB) Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the thresholds for reporting are defined in the circular. Those reporting thresholds satisfy GAGAS.

\(^65\)The term "more than remote" used in the definitions for significant deficiency and material weakness means "at least reasonably possible." The following definitions apply: (1) Remote—The chance of the future events occurring is slight. (2) Reasonably possible—The chance of the future events or their occurrence is more than remote but less than likely. (3) Probable—The future events are likely to occur.
more than inconsequential\textsuperscript{66} will not be prevented or detected.\textsuperscript{67}

b. Material weakness: a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

5.12 Assessing the significance of control deficiencies includes qualitative considerations such as public accountability of the audited entity, legal and regulatory requirements, the visibility and sensitivity of the entity or program, the needs of users and concerns of oversight officials, and current and emerging risks and uncertainties facing the government entity or entity that receives government funding. The significance of a deficiency in internal control also is influenced by

a. the likelihood that a deficiency, or combination of deficiencies, could fail to prevent or detect a material misstatement of an account balance or disclosure; and

b. the magnitude of the potential misstatement.

\textsuperscript{66}The phrase “more than inconsequential” as used in the definition of significant deficiency describes the magnitude of potential misstatement that could occur as a result of a significant deficiency and serves as a threshold for evaluating whether a control deficiency or combination of control deficiencies is a significant deficiency. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

\textsuperscript{67}See appendix I, paragraph A.04 for examples of control deficiencies. AU Section 325, \textit{Communicating Internal Control Related Matters Identified in an Audit}, also provides guidance on evaluating potential control deficiencies and examples.
5.13 Auditors should include all significant deficiencies in the auditors’ report on internal control over financial reporting and indicate those that represent material weaknesses. If (1) a significant deficiency is remediated before the auditors’ report is issued and (2) the auditors obtain sufficient, appropriate evidence supporting the remediation of the significant deficiency, then the auditors should report the significant deficiency and the fact that it was remediated before the auditors’ report was issued.

5.14 Determining whether and how to communicate to officials of the audited entity internal control deficiencies that have an inconsequential effect on the financial statements is a matter of professional judgment. Auditors should document such communications.

5.15 Under AICPA standards and GAGAS, auditors have responsibilities for detecting fraud and illegal acts that have a material effect on the financial statements and determining whether those charged with governance are adequately informed about fraud and illegal acts. GAGAS include additional reporting standards. When auditors conclude, based on sufficient, appropriate evidence, that any of the following either has occurred or is likely to have occurred, they should include in their audit report the relevant information about

a. fraud and illegal acts that have an effect on the financial statements that is more than inconsequential,

b. violations of provisions of contracts or grant agreements that have a material effect on the

68Whether a particular act is, in fact, illegal may have to await final determination by a court of law or other adjudicative body. Disclosing matters that have led auditors to conclude that an illegal act is likely to have occurred is not a final determination of illegality.
determination of financial statement amounts or other financial data significant to the audit, and

c. abuse that is material, either quantitatively or qualitatively. (See paragraphs 4.12 and 4.13 for a discussion of abuse.)

5.16 When auditors detect violations of provisions of contracts or grant agreements or abuse that have an effect on the financial statements that is less than material but more than inconsequential, they should communicate those findings in writing to officials of the audited entity. Determining whether and how to communicate to officials of the audited entity fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that is inconsequential is a matter of professional judgment. Auditors should document such communications.

5.17 When fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse either have occurred or are likely to have occurred, auditors may consult with authorities or legal counsel about whether publicly reporting such information would compromise investigative or legal proceedings. Auditors may limit their public reporting to matters that would not compromise those proceedings, and for example, report only on information that is already a part of the public record.

5.18 Auditors should report known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse directly to parties outside the audited entity in the following two circumstances.69

69Internal audit organizations do not have a duty to report outside the entity unless required by law, rule, regulation, or policy. (See paragraph 5.44b for reporting standards for internal audit organizations when reporting externally.)
a. When entity management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, auditors should first communicate the failure to report such information to those charged with governance. If the audited entity still does not report this information to the specified external parties as soon as practicable after the auditors’ communication with those charged with governance, then the auditors should report the information directly to the specified external parties.

b. When entity management fails to take timely and appropriate steps to respond to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that (1) is likely to have a material effect on the financial statements and (2) involves funding received directly or indirectly from a government agency, auditors should first report management’s failure to take timely and appropriate steps to those charged with governance. If the audited entity still does not take timely and appropriate steps as soon as practicable after the auditors’ communication with those charged with governance, then the auditors should report the entity’s failure to take timely and appropriate steps directly to the funding agency.

5.19 The reporting in paragraph 5.18 is in addition to any legal requirements to report such information directly to parties outside the audited entity. Auditors should comply with these requirements even if they have resigned or been dismissed from the audit prior to its completion.

5.20 Auditors should obtain sufficient, appropriate evidence, such as confirmation from outside parties, to corroborate assertions by management of the audited entity that it has reported such findings in accordance with laws, regulations, and funding agreements. When
auditors are unable to do so, they should report such information directly as discussed in paragraph 5.18.

5.21 In presenting findings such as deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse, auditors should develop the elements of the findings to the extent necessary to achieve the audit objectives. Clearly developed audit findings, as discussed in paragraphs 4.14 through 4.18, assist management or oversight officials of the audited entity in understanding the need for taking corrective action. If auditors sufficiently develop the elements of a finding, they may provide recommendations for corrective action.

5.22 Auditors should place their findings in perspective by describing the nature and extent of the issues being reported and the extent of the work performed that resulted in the finding. To give the reader a basis for judging the prevalence and consequences of these findings, auditors should, as applicable, relate the instances identified to the population or the number of cases examined and quantify the results in terms of dollar value or other measures, as appropriate. If the results cannot be projected, auditors should limit their conclusions appropriately.

5.23 Under AICPA standards, auditors may emphasize in the auditors’ report significant matters regarding the financial statements.70 Due to the public interest in the operations of government entities and entities that receive or administer government awards, there may be situations in GAGAS audits in which certain types of information would help facilitate the readers’

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70AU Section 508.19 establishes standards and provides guidance on emphasis of a matter in an auditors’ report.
understanding of the financial statements and the auditors’ report. These situations may be in addition to the examples presented in AICPA standards.

5.24 Examples of matters that auditors may communicate in a GAGAS audit include the following:

a. Significant concerns or uncertainties about the fiscal sustainability of a government or program or other matters that could have a significant impact on the financial condition or operations of the government entity beyond 1 year of the financial statement date. Such concerns or uncertainties may arise due to revenue or expenditure trends; economic dependency on other governments or entities; the government’s current commitments, responsibilities, liabilities, or promises to citizens for future benefits that are not sustainable over the long term; deficit trends; the relationship between the financial information and other key indicators; and other significant risks and uncertainties that raise doubts about the long-term sustainability of current government programs in relation to the resources expected to be available. However, auditors are not responsible for designing audit procedures to detect such concerns or uncertainties, and any judgment about the future is based on information that is available at the time the judgment is made.

b. Unusual or catastrophic events that will likely have a significant ongoing or future impact on the entity’s financial condition or operations.

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71AU Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, establishes standards and provides guidance on auditor responsibilities with regard to an entity’s ability to continue as a going concern for a reasonable period of time, not to exceed 1 year beyond the date of the financial statements being audited.
c. Significant uncertainties surrounding projections or estimations in the financial statements.

d. Any other matter that the auditors consider significant for communication to users and oversight bodies in the auditors’ report.

5.25 Determining whether to communicate such information in the auditors’ report is a matter of professional judgment. The communication may be presented in a separate paragraph or separate section of the auditors’ report and may include information that is not disclosed in the financial statements.

5.26 AICPA Professional Standards, AU Section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report*, establish standards and provide guidance for situations when auditors become aware of new information that could have affected their report on previously-issued financial statements. Under AU Section 561, if auditors become aware of new information that might have affected their opinion on previously-issued financial statement(s), then the auditors should advise entity management to determine the potential effect(s) of the new information on the previously-issued financial statement(s) as soon as reasonably possible. Such new information may lead management to conclude that previously-issued financial statements were materially misstated and to restate and reissue the misstated financial statements. In such circumstances, auditors should advise management to make appropriate disclosure of the newly discovered facts and their impact on the financial statements.

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72AU Section 420, *Consistency of Application of GAAP*, and AU Section 508, *Reports on Audited Financial Statements*, provide guidance on when to reissue auditors’ reports on restated financial statements.
Chapter 5
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statements to those who are likely to rely on the financial statements.73

5.27 Under GAGAS, auditors should advise management to make appropriate disclosures when the auditors believe that the following conditions exist: (1) it is likely that previously-issued financial statements are misstated and (2) the misstatement is or reasonably could be material. Under GAGAS, auditors also should perform the following procedures related to restated financial statements:74

a. evaluate the timeliness and appropriateness of management’s disclosure and actions to determine and correct misstatements in previously-issued financial statements (see paragraph 5.28),

b. report on restated financial statements (see paragraphs 5.29 and 5.30), and

c. report directly to appropriate officials when the audited entity does not take the necessary steps (see paragraph 5.31).

Evaluate the Timeliness and Appropriateness of Management’s Disclosure and Actions to Determine and Correct Misstatements in Previously-Issued Financial Statements

5.28 Auditors should evaluate the timeliness and appropriateness of management’s disclosure to those who are likely to rely on the financial statements and management’s actions to determine and correct misstatements in previously-issued financial statements in accordance with AU Sections 561.06 through 561.08. Under GAGAS, auditors also should evaluate whether management

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73In GAGAS audits, those likely to rely on the financial statements include, at a minimum, those charged with governance, appropriate oversight bodies, and funding agencies.

74These additional GAGAS requirements also apply to other financial information on which auditors opine, such as schedules of expenditures of federal awards.
a. acted in an appropriate time frame after new information was available to (1) determine the financial statement effects of the new information and (2) notify those who are likely to rely on the financial statements;

b. disclosed the nature and extent of the known or likely material misstatements on Web pages where management has published the auditors’ report on the previously-issued financial statements; and

c. disclosed the following information in the entity’s restated financial statements: (1) the nature and cause(s) of the misstatement(s) that led to the need for restatement, (2) the specific amount(s) of the material misstatement(s), and (3) the related effect(s) on the previously-issued financial statement(s) (e.g., year(s) being restated, specific financial statement(s) affected and line items restated, actions the agency’s management took after discovering the misstatement), and (4) the impact on the financial statements as a whole (e.g., change in overall net position, change in the audit opinion) and on key information included in the Management Discussion & Analysis.

5.29 When management restates financial statements, auditors should perform audit procedures sufficient to reissue or update the auditors’ report on the restated financial statements regardless of whether the restated financial statements are separately issued or presented on a comparative basis with those of a subsequent period.75 Auditors should include the following in an explanatory paragraph in the reissued or updated auditors’ report:

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75AU Section 9561.02 provides guidance on auditor association with subsequently discovered information when the auditor has resigned or been discharged. AU Sections 508.70 through 508.73 discusses reissuing predecessor auditors’ reports.
a. a statement disclosing that the previously-issued financial statements have been restated;

b. a statement that (1) the previously-issued auditors’ report (identified by report date) is not to be relied on because the previously-issued financial statements were materially misstated and (2) the previously-issued auditors’ report is replaced by the auditors’ report on the restated financial statements;

c. a reference to the note(s) to the restated financial statements that discusses the restatement; and

d. if applicable, a reference to the report on internal control containing a discussion of any significant internal control deficiency identified by the auditors as having failed to prevent or detect the misstatement and any corrective action taken by management to address the deficiency.

5.30 Management’s failure to include appropriate disclosures, as discussed in paragraph 5.28c, in restated financial statements may have implications for the audit. In addition, auditors should include the omitted disclosures in the auditors’ report, if practicable.

5.31 Auditors should notify those charged with governance if entity management (1) does not act in an appropriate time frame after new information was available to determine the financial statement effects of the new information and take the necessary steps to timely inform those who are likely to rely on the financial statements and the related auditors’ reports of the situation or (2) does not restate with reasonable timeliness the financial statements under circumstances in which auditors believe they need to be restated. Auditors should inform those charged with governance that the auditors will take steps to prevent further reliance on the auditors’ report and advise them to
notify oversight bodies and funding agencies that rely on the financial statements. If those charged with governance do not notify appropriate oversight bodies and funding agencies, then the auditors should do so.\(^76\)

### Reporting Views of Responsible Officials

5.32 If the auditors’ report discloses deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse, auditors should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions.

5.33 Providing a draft report with findings for review and comment by responsible officials of the audited entity and others helps the auditors develop a report that is fair, complete, and objective. Including the views of responsible officials results in a report that presents not only the auditors’ findings, conclusions, and recommendations, but also the perspectives of the responsible officials of the audited entity and the corrective actions they plan to take. Obtaining the comments in writing is preferred, but oral comments are acceptable.

5.34 When auditors receive written comments from the responsible officials, they should include in their report a copy of the officials’ written comments, or a summary of the comments received. When the responsible officials provide oral comments only, auditors should prepare a summary of the oral comments and provide a copy of the summary to the responsible officials to verify that the comments are accurately stated.

\(^{76}\)The steps taken will depend on the facts and circumstances, including legal considerations.
5.35 Auditors should also include in the report an evaluation of the comments, as appropriate. In cases in which the audited entity provides technical comments in addition to its written or oral comments on the report, auditors may disclose in the report that such comments were received.

5.36 Obtaining oral comments may be appropriate when, for example, there is a reporting date critical to meeting a user's needs; auditors have worked closely with the responsible officials throughout the conduct of the work and the parties are familiar with the findings and issues addressed in the draft report; or the auditors do not expect major disagreements with findings, conclusions, and recommendations in the draft report, or major controversies with regard to the issues discussed in the draft report.

5.37 When the audited entity's comments are inconsistent or in conflict with findings, conclusions, or recommendations in the draft report, or when planned corrective actions do not adequately address the auditors' recommendations, the auditors should evaluate the validity of the audited entity's comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement. Conversely, the auditors should modify their report as necessary if they find the comments valid and supported with sufficient, appropriate evidence.

5.38 If the audited entity refuses to provide comments or is unable to provide comments within a reasonable period of time, the auditors may issue the report without receiving comments from the audited entity. In such cases, the auditors should indicate in the report that the audited entity did not provide comments.
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5.39 If certain pertinent information is prohibited from public disclosure or is excluded from a report due to the confidential or sensitive nature of the information, auditors should disclose in the report that certain information has been omitted and the reason or other circumstances that make the omission necessary.

5.40 Certain information may be classified or may otherwise be prohibited from general disclosure by federal, state, or local laws or regulations. In such circumstances, auditors may issue a separate, classified, or limited use report containing the information and distribute the report only to persons authorized by law or regulation to receive it.

5.41 Additional circumstances associated with public safety and security concerns could also justify the exclusion of certain information from a publicly available or widely distributed report. For example, detailed information related to computer security for a particular program may be excluded from publicly available reports because of the potential damage that could be caused by the misuse of this information. In such circumstances, auditors may issue a limited use report containing such information and distribute the report only to those parties responsible for acting on the auditors’ recommendations. The auditors may consult with legal counsel regarding any requirements or other circumstances that may necessitate the omission of certain information.

5.42 Considering the broad public interest in the program or activity under review assists auditors when deciding whether to exclude certain information from publicly available reports. When circumstances call for omission of certain information, auditors should evaluate whether this omission could distort the audit results or conceal improper or illegal practices.
5.43 When audit organizations are subject to public records laws, auditors should determine whether public records laws could impact the availability of classified or limited use reports and determine whether other means of communicating with management and those charged with governance would be more appropriate. For example, the auditors may communicate general information in a written report and communicate detailed information verbally. The auditors may consult with legal counsel regarding applicable public records laws.

Distributing Reports

5.44 Distribution of reports completed under GAGAS depends on the relationship of the auditors to the audited organization and the nature of the information contained in the report. If the subject of the audit involves material that is classified for security purposes or contains confidential or sensitive information, auditors may limit the report distribution. Auditors should document any limitation on report distribution. The following discussion outlines distribution for reports completed under GAGAS:

a. Audit organizations in government entities should distribute audit reports to those charged with governance, to the appropriate officials of the audited entity, and to the appropriate oversight bodies or organizations requiring or arranging for the audits. As appropriate, auditors should also distribute copies of the reports to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations, and to others authorized to receive such reports.

b. Internal audit organizations in government entities may follow the Institute of Internal Auditors (IIA) International Standards for the Professional Practice of Internal Auditing. Under GAGAS and IIA standards, the head of the internal audit organization should
communicate results to the parties who can ensure that the results are given due consideration. If not otherwise mandated by statutory or regulatory requirements, prior to releasing results to parties outside the organization, the head of the internal audit organization should:
(1) assess the potential risk to the organization,
(2) consult with senior management and/or legal counsel as appropriate, and
(3) control dissemination by indicating the intended users in the report.

c. Public accounting firms contracted to perform an audit under GAGAS should clarify report distribution responsibilities with the engaging organization. If the contracted firm is to make the distribution, it should reach agreement with the party contracting for the audit about which officials or organizations will receive the report and the steps being taken to make the report available to the public.
## Introduction

**6.01** This chapter establishes standards and provides guidance for attestation engagements conducted in accordance with generally accepted government auditing standards (GAGAS). For attestation engagements, GAGAS incorporate the American Institute of Certified Public Accountants (AICPA) general standard on criteria, and the field work and reporting standards and the related Statements on Standards for Attestation Engagements (SSAE), unless specifically excluded or modified by GAGAS.\(^{77,78}\) This chapter identifies the AICPA general standard on criteria\(^{79}\) and the field work and reporting standards for attestation engagements and prescribes additional standards for attestation engagements performed in accordance with GAGAS.

**6.02** For attestation engagements performed in accordance with GAGAS, chapters 1 through 3 and 6 apply.

## AICPA General and Field Work Standards for Attestation Engagements

**6.03** The AICPA general standard related to criteria is as follows:

The practitioner [auditor] must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to users.

**6.04** The two AICPA field work standards for attestation engagements are as follows:

\(^{77}\)To date, the Comptroller General has not excluded any field work standards, reporting standards, or SSAE.

\(^{78}\)See AT Section 50, SSAE Hierarchy.

\(^{79}\)GAGAS incorporate only one of the AICPA general standards for attestation engagements.
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a. The practitioner [auditor] must adequately plan the work and must properly supervise any assistants.

b. The practitioner [auditor] must obtain sufficient evidence to provide a reasonable basis for the conclusion that is expressed in the report.

Additional Government Auditing Standards

6.05 GAGAS establish attestation engagement field work standards in addition to the requirements contained in the AICPA standards. Auditors should comply with these additional standards when citing GAGAS in their attestation engagement reports. The additional government auditing standards relate to

a. auditor communication during planning (see paragraphs 6.06 through 6.08);

b. previous audits and attestation engagements (see paragraph 6.09);

c. internal control (see paragraphs 6.10 through 6.12);

d. fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that could have a material effect on the subject matter (see paragraphs 6.13 and 6.14);

e. developing elements of a finding (see paragraphs 6.15 through 6.19); and

f. documentation (see paragraphs 6.20 through 6.26).

Auditor Communication During Planning

6.06 Under AICPA standards and GAGAS, auditors should establish an understanding with the entity regarding the services to be performed for each engagement. Auditors also should obtain written acknowledgment or other evidence of the entity's
responsibilities for the subject matter or the written assertion as it relates to the objectives of the engagement. GAGAS broaden the parties included in the communications during planning and contain additional items in the communications.

**6.07** Under GAGAS, when planning the engagement, auditors should communicate certain information, including their understanding of the services to be performed for each engagement, in writing to entity management, those charged with governance,80 and to the individuals contracting for or requesting the engagement. When auditors perform the engagement pursuant to a law or regulation or they conduct the work for the legislative committee that has oversight of the entity, auditors should communicate with the legislative committee. In those situations where there is not a single individual or group that both oversees the strategic direction of the entity and the fulfillment of its accountability obligations or in other situations where the identity of those charged with governance is not clearly evident, the auditors should document the process followed and conclusions reached for identifying the appropriate individuals to receive the required auditor communications. Auditors should communicate the following additional information under GAGAS:

**a.** the nature, timing, and extent of planned testing and reporting;

**b.** the level of assurance the auditor will provide; and

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80Those charged with governance are those responsible for overseeing the strategic direction of the entity and the entity’s fulfillment of its obligations related to accountability. (See appendix I, paragraph A1.05 through A1.07 for additional information.)
6.08 If an engagement is terminated before it is completed and a report is not issued, auditors should document the results of the work to the date of termination and why the engagement was terminated. Determining whether and how to communicate the reason for terminating the engagement to those charged with governance, appropriate officials of the entity, the entity contracting for or requesting the engagement, and other appropriate officials will depend on the facts and circumstances and, therefore, is a matter of professional judgment.

6.09 Auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the subject matter. When planning the engagement, auditors should ask entity management to identify previous audits, attestation engagements, and other studies that directly relate to the subject matter of the attestation engagement being undertaken, including whether related recommendations have been implemented. Auditors should use this information in assessing risk and determining the nature, timing, and extent of current work, including determining the extent to which testing the implementation of the corrective actions is applicable to the current engagement objectives.

6.10 In planning examination-level attestation engagements, auditors should obtain a sufficient understanding of internal control that is material to the subject matter in order to plan the engagement and design procedures to achieve the objectives of the attestation engagement.
6.11 In planning an examination-level attestation engagement, auditors should obtain an understanding of internal control as it relates to the subject matter to which the auditors are attesting. The subject matter may be financial or nonfinancial. (See paragraph 1.23 for a discussion of possible attestation engagement subject matters.)

6.12 A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, detect, or correct errors in assertions made by management on a timely basis. A deficiency in design exists when (1) a control necessary to meet the control objective is missing or (2) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not met. A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.
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Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, or Abuse That Could Have a Material Effect on the Subject Matter

6.13 The auditors’ responsibility with regard to fraud,\textsuperscript{81} illegal acts, violations of provisions of contracts or grant agreements, or abuse for attestation engagements performed in accordance with GAGAS is as follows:

**a.** Examination-level engagements: In planning, auditors should design the engagement to provide reasonable assurance of detecting fraud, illegal acts, or violations of provisions of contracts or grant agreements that could have a material effect on the subject matter of the attestation engagement. Thus, auditors should assess the risk and possible effects of material fraud, illegal acts, or violations of provisions of contracts or grant agreements on the subject matter of the attestation engagement. When risk factors are identified, auditors should document the risk factors identified, the auditors’ response to those risk factors individually or in combination, and the auditors’ conclusions.

**b.** Review-level and agreed-upon-procedures-level engagements: If during the course of the engagement, information comes to the auditors’ attention indicating that fraud, illegal acts, or violations of provisions of contracts or grant agreements that could have a material effect on the subject matter may have occurred, auditors should perform procedures as necessary to (1) determine if fraud, illegal acts, or violations of provisions of contracts or grant agreements are likely to have occurred and, if so, (2) determine their effect on the results of the attestation engagement. Auditors are not expected to provide assurance of detecting potential fraud, illegal acts, or violations of provisions of contracts or grant agreements.

\textsuperscript{81}Fraud is a type of illegal act involving the obtaining of something of value through willful misrepresentation. Although not applicable to attestation engagements, the AICPA Statements on Auditing Standards (SAS) may provide useful guidance related to fraud for auditors performing attestation engagements in accordance with GAGAS.
contracts or grant agreements for these types of engagements unless it is specified in the procedures.

c. For all levels of attestation engagements: If during the course of the engagement, auditors become aware of abuse that could be quantitatively or qualitatively material, auditors should apply procedures specifically directed to ascertain the potential effect on the subject matter or other data significant to the engagement objectives. After performing additional work, auditors may discover that the abuse represents potential fraud or illegal acts. Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse in attestation engagements.

6.14 Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. Abuse does not necessarily involve fraud, violation of laws, regulations, or provisions of a contract or grant agreement.

Developing Elements of a Finding

6.15 Audit findings may involve deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse. The elements needed for a finding depend entirely on the engagement objectives. Thus a finding or set of findings is complete to the extent that the engagement objectives are satisfied. When auditors identify deficiencies, auditors should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the engagement objectives. The elements of a finding are discussed in paragraphs 6.16 through 6.19.
6.16 Criteria: The laws, regulations, contracts, grant agreements, standards, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated. Criteria identify the required or desired state or expectation with respect to the program or operation. Criteria provide a context for evaluating evidence and understanding the findings.

6.17 Condition: Condition is a situation that exists. The condition is determined and documented during the engagement.

6.18 Cause: The cause identifies the reason or explanation for the condition or the factor or factors responsible for the difference between the situation that exists (condition) and the required or desired state (criteria), which may also serve as a basis for recommendations for corrective actions. Common factors include poorly designed policies, procedures, or criteria; inconsistent, incomplete, or incorrect implementation; or factors beyond the control of program management. Auditors may assess whether the evidence provides a reasonable and convincing argument for why the stated cause is the key factor or factors contributing to the difference.

6.19 Effect or potential effect: The effect is a clear, logical link to establish the impact or potential impact of the difference between the situation that exists (condition) and the required or desired state (criteria). The effect or potential effect identifies the outcomes or consequences of the condition. When the engagement objectives include identifying the actual or potential consequences of a condition that varies (either positively or negatively) from the criteria identified in the engagement, “effect” is a measure of those consequences. Effect or potential effect may be used to
demonstrate the need for corrective action in response to identified problems or relevant risks.

**Attest Documentation**

**6.20** Under GAGAS, auditors must prepare attest documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of engagement procedures performed); the evidence obtained and its source; and the conclusions reached. Documentation provides the principal support for:

- a. the statement in the engagement report that the auditors performed the attestation engagement in accordance with GAGAS and any other standards cited and

- b. the auditors’ conclusion.

**6.21** Auditors should prepare attest documentation in sufficient detail to enable an experienced auditor, having no previous connection to the attestation engagement, to understand from the documentation the nature, timing, extent, and results of procedures performed and the evidence obtained and its source and the conclusions reached, including evidence that supports the auditors’ significant judgments and conclusions. Auditors should prepare attest documentation that contains support for findings,

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**82** An experienced auditor means an individual (whether internal or external to the audit organization) who possesses the competencies and skills that would have enabled him or her to perform the attestation engagement. These competencies and skills include an understanding of (1) attestation engagement processes, (2) GAGAS and applicable legal and regulatory requirements, (3) the subject matter that the auditor is engaged to report on, (4) the suitability and availability of criteria, and (5) issues related to the audited entity’s environment.
conclusions, and recommendations before they issue their report.

6.22 Auditors also should document the following for attestation engagements performed under GAGAS:

   a. the objectives, scope, and methodology of the attestation engagement;

   b. the work performed to support significant judgments and conclusions, including descriptions of transactions and records examined;\(^{83}\)

   c. evidence of supervisory review, before the engagement report is issued, of the work performed that supports findings, conclusions, and recommendations contained in the engagement report; and

   d. the auditors’ consideration that the planned procedures be designed to achieve objectives of the attestation engagement when (1) evidence obtained is dependent on computerized information systems, (2) such evidence is material to the objective of the engagement, and (3) the auditors are not relying on the effectiveness of internal control over those computerized systems that produced the evidence. Auditors should document (1) the rationale for determining the nature, timing, and extent of planned procedures; (2) the kinds and competence of available evidence produced outside a computerized information system, or plans for direct testing of data produced from a computerized information system; and (3) the effect on the attestation engagement report if evidence to be

\(^{83}\)Auditors may meet this requirement by listing file numbers, case numbers, or other means of identifying specific documents they examined. They are not required to include copies of documents they examined as part of the attest documentation, nor are they required to list detailed information from those documents.
gathered does not afford a reasonable basis for achieving the objectives of the engagement.

6.23 When auditors do not comply with applicable GAGAS requirements due to law, regulation, scope limitations, restrictions on access to records, or other issues impacting the engagement, the auditors should document the departure, the impact on the engagement and on the auditors’ conclusions. This applies to departures from mandatory requirements and presumptively mandatory requirements where alternative procedures performed in the circumstances were not sufficient to achieve the objectives of the standard. (See paragraphs 1.12 and 1.13.)

6.24 Audit organizations should establish policies and procedures for the safe custody and retention of documentation for a time sufficient to satisfy legal, regulatory, and administrative requirements for records retention. Whether engagement 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 attest documentation that is retained electronically, the audit organization should establish information systems controls concerning accessing and updating the attest documentation.

6.25 Underlying GAGAS engagements is the premise that audit organizations in federal, state, and local governments and public accounting firms engaged to perform an engagement in accordance with GAGAS cooperate in performing attestation engagements of programs of common interest so that auditors may use others’ work and avoid duplication of efforts. Subject to applicable laws and regulations, auditors should make appropriate individuals, as well as attest documentation,
available upon request and in a timely manner to other auditors or reviewers to satisfy these objectives. The use of auditors’ work by other auditors may be facilitated by contractual arrangements for GAGAS engagements that provide for full and timely access to appropriate individuals, as well as attest documentation.

6.26 Audit organizations should develop policies to deal with requests by outside parties to obtain access to attest documentation, especially when an outside party attempts to obtain information indirectly through the auditor rather than directly from the entity. In developing such policies, audit organizations should determine what laws and regulations apply, if any.

Additional Considerations for GAGAS Attestation Engagements

6.27 Due to the engagement objectives and public accountability of GAGAS engagements, there may be additional considerations for attestation engagements completed in accordance with GAGAS. These considerations relate to

a. materiality in GAGAS attestation engagements (see paragraph 6.28) and

b. ongoing investigations or legal proceedings (see paragraph 6.29).

Materiality in GAGAS Attestation Engagements

6.28 The concept of materiality recognizes that some matters, either individually or in the aggregate, are important for fair presentation of a subject matter or an assertion about a subject matter, while other matters are not important. In performing the engagement, matters that, either individually or in the aggregate, could be material to the subject matter are a primary consideration. In engagements performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the
materiality levels used in non-GAGAS engagements because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.

### Ongoing Investigations or Legal Proceedings

**6.29** Avoiding interference with investigations or legal proceedings is important in pursuing indications of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse. Laws, regulations, or policies might require auditors to report indications of certain types of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse to law enforcement or investigatory authorities before performing additional procedures. When investigations or legal proceedings are initiated or in process, auditors should evaluate the impact on the current engagement. In some cases, it may be appropriate for the auditors to work with investigators and/or legal authorities, or withdraw from or defer further work on the engagement or a portion of the engagement to avoid interfering with an investigation.

### AICPA Reporting Standards for Attestation Engagements

**6.30** The four AICPA reporting standards that apply to all levels of attestation engagements are as follows:  

a. The practitioner [auditor] must identify the subject matter or the assertion being reported on and state the character of the engagement in the report.

b. The practitioner [auditor] must state the practitioner’s [auditor’s] conclusion about the subject matter or the

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84 Under AT Section 50, SSAE Hierarchy, the reporting standards apply when the practitioner issues a report. The reporting standards do not apply when the practitioner declines to issue a report as a result of the engagement.
assertion in relation to the criteria against which the subject matter was evaluated in the report.

c. The practitioner [auditor] must state all of the practitioner’s [auditor’s] significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto in the report.

d. The practitioner [auditor] must state in the report that the report is intended for use by specified parties under the following circumstances:

(1) When the criteria used to evaluate the subject matter are determined by the practitioner [auditor] to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria.

(2) When the criteria used to evaluate the subject matter are available only to specified parties.

(3) When reporting on subject matter and a written assertion has not been provided by the responsible party.

(4) When the report is on an attest engagement to apply agreed-upon procedures to the subject matter.

Additional Government Auditing Standards

6.31 GAGAS establish reporting standards for attestation engagements in addition to the requirements contained in the AICPA standards. Auditors should comply with these additional standards when citing GAGAS in their attestation engagement reports. The additional government auditing standards relate to

a. reporting auditors’ compliance with GAGAS (see paragraph 6.32);
b. reporting deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse (see paragraphs 6.33 through 6.43);

c. reporting views of responsible officials (see paragraphs 6.44 through 6.50);

d. reporting confidential or sensitive information (see paragraphs 6.51 through 6.55); and

e. distributing reports (see paragraph 6.56).

Reporting Auditors’ Compliance with GAGAS

6.32 When auditors comply with all applicable GAGAS requirements, they should include a statement in the attestation report that they performed the engagement in accordance with GAGAS. (See paragraphs 1.12 and 1.13 for additional requirements on citing compliance with GAGAS.) GAGAS do not prohibit auditors from issuing a separate report conforming only to the requirements of other standards.

Reporting Deficiencies in Internal Control, Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, and Abuse

6.33 For attestation engagements, auditors should report, as applicable to the objectives of the engagement, and based upon the work performed, (1) significant deficiencies in internal control, identifying those considered to be material weaknesses; (2) all instances of fraud and illegal acts unless inconsequential; and (3) violations of provisions of contracts or grant agreements and abuse that could have a material effect on the subject matter of the engagement.

6.34 For all attestation engagements, auditors should report the following deficiencies in internal control:
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a. Significant deficiency: a deficiency in internal control, or combination of deficiencies, that adversely affects the entity’s ability to initiate, authorize, record, process, or report data reliably in accordance with the applicable criteria or framework such that there is more than a remote\(^{85}\) likelihood that a misstatement of the subject matter that is more than inconsequential\(^{86}\) will not be prevented or detected.

b. Material weakness: a significant deficiency or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the subject matter will not be prevented or detected.

6.35 Determining whether and how to communicate to entity officials internal control deficiencies that have an inconsequential effect on the subject matter is a matter of professional judgment. Auditors should document such communications.

6.36 Under GAGAS, when auditors conclude, based on sufficient, appropriate evidence, that any of the following either has occurred or is likely to have occurred, they should include in their report the relevant information about

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\(^{85}\)The term “more than remote” used in the definitions for significant deficiency and material weakness means “at least reasonably possible.” The following definitions apply: (1) Remote—The chance of the future events occurring is slight. (2) Reasonably possible—The chance of the future events or their occurrence is more than remote but less than likely. (3) Probable—The future events are likely to occur.

\(^{86}\)“More than inconsequential” indicates an amount that is less than material, yet has significance. A misstatement is “inconsequential” if a reasonable person would conclude that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the subject matter. If a reasonable person would not reach such a conclusion, that misstatement is “more than inconsequential.”
a. fraud and illegal acts that have an effect on the subject matter that is more than inconsequential,

b. violations of provisions of contracts or grant agreements that have a material effect on the subject matter, and

c. abuse that is material to the subject matter, either quantitatively or qualitatively. (See paragraphs 6.13 and 6.14 for a discussion of abuse.)

6.37 When auditors detect violations of provisions of contracts or grant agreements or abuse that have an effect on the subject matter that is less than material but more than inconsequential, they should communicate those findings in writing to entity officials. Determining whether and how to communicate to entity officials fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that is inconsequential is a matter of professional judgment. Auditors should document such communications.

6.38 When fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse either have occurred or are likely to have occurred, auditors may consult with authorities or legal counsel about whether publicly reporting such information would compromise investigative or legal proceedings. Auditors may limit their public reporting to matters that would not compromise those proceedings and, for example, report only on information that is already a part of the public record.

87Whether a particular act is, in fact, illegal may have to await final determination by a court of law or other adjudicative body. Disclosing matters that have led auditors to conclude that an illegal act is likely to have occurred is not a final determination of illegality.
6.39 Auditors should report known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse directly to parties outside the audited entity in the following two circumstances.\(^{88}\)

a. When entity management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, auditors should first communicate the failure to report such information to those charged with governance. If the audited entity still does not report this information to the specified external parties as soon as practicable after the auditors’ communication with those charged with governance, then the auditors should report the information directly to the specified external parties.

b. When entity management fails to take timely and appropriate steps to respond to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that (1) is likely to have a material effect on the subject matter and (2) involves funding received directly or indirectly from a government agency, auditors should first report management’s failure to take timely and appropriate steps to those charged with governance. If the audited entity still does not take timely and appropriate steps as soon as practicable after the auditors’ communication with those charged with governance, then the auditors should report the entity’s failure to take timely and appropriate steps directly to the funding agency.

6.40 The reporting in paragraph 6.39 is in addition to any legal requirements to report such information directly to parties outside the entity. Auditors should

\(^{88}\)Internal audit organizations do not have a duty to report outside the entity unless required by law, rule, regulation, or policy. (See paragraph 6.56b for reporting standards for internal audit organizations when reporting externally.)
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...comply with these requirements even if they have resigned or been dismissed from the engagement prior to its completion.

6.41 Auditors should obtain sufficient, appropriate evidence, such as confirmation from outside parties, to corroborate assertions by entity management that it has reported such findings in accordance with laws, regulations, and funding agreements. When auditors are unable to do so, they should report such information directly as discussed in paragraph 6.39.

Presenting Findings in the Auditors’ Report

6.42 In presenting findings such as deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse, auditors should develop the elements of the findings to the extent necessary to achieve the engagement objectives. Clearly developed findings, as discussed in paragraphs 6.15 through 6.19, assist management or oversight officials in understanding the need for taking corrective action. If auditors are able to sufficiently develop the elements of a finding, they may provide recommendations for corrective action.

6.43 Auditors should place their findings in perspective by describing the nature and extent of the issues being reported and the extent of the work performed that resulted in the finding. To give the reader a basis for judging the prevalence and consequences of these findings, auditors should, as applicable, relate the instances identified to the population or the number of cases examined and quantify the results in terms of dollar value or other measures, as appropriate. If the results cannot be projected, auditors should limit their conclusions appropriately.

Reporting Views of Responsible Officials

6.44 If the attestation engagement report discloses deficiencies in internal control, fraud, illegal acts,
violations of provisions of contracts or grant agreements, or abuse, auditors should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions.

6.45 Providing a draft report with findings for review and comment by responsible officials of the audited entity and others helps the auditors develop a report that is fair, complete, and objective. Including the views of responsible officials results in a report that presents not only the auditors’ findings, conclusions, and recommendations, but also the perspectives of the responsible officials of the audited entity and the corrective actions they plan to take. Obtaining the comments in writing is preferred, but oral comments are acceptable.

6.46 When auditors receive written comments from the responsible officials, they should include in their report a copy of the officials' written comments, or a summary of the comments received. When the responsible officials provide oral comments only, auditors should prepare a summary of the oral comments and provide a copy of the summary to the responsible officials to verify that the comments are accurately stated.

6.47 Auditors should also include in the report an evaluation of the comments, as appropriate. In cases in which the audited entity provides technical comments in addition to its written or oral comments on the report, auditors may disclose in the report that such comments were received.

6.48 Obtaining oral comments may be appropriate when, for example, there is a reporting date critical to meeting a user's needs; auditors have worked closely with the responsible officials throughout the conduct of the work and the parties are familiar with the findings.
and issues addressed in the draft report; or the auditors do not expect major disagreements with the findings, conclusions, and recommendations in the draft report, or major controversies with regard to the issues discussed in the draft report.

6.49 When the entity’s comments are inconsistent or in conflict with the findings, conclusions, or recommendations in the draft report, or when planned corrective actions do not adequately address the auditors’ recommendations, the auditors should evaluate the validity of the audited entity’s comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement. Conversely, the auditors should modify their report as necessary if they find the comments valid and supported with sufficient, appropriate evidence.

6.50 If the entity refuses to provide comments or is unable to provide comments within a reasonable period of time, the auditors may issue the report without receiving comments from the entity. In such cases, the auditors should indicate in the report that the audited entity did not provide comments.

6.51 If certain pertinent information is prohibited from public disclosure or is excluded from a report due to the confidential or sensitive nature of the information, auditors should disclose in the report that certain information has been omitted and the reason or other circumstances that make the omission necessary.

6.52 Certain information may be classified or may be otherwise prohibited from general disclosure by federal, state, or local laws or regulations. In such circumstances, auditors may issue a separate classified or limited use report containing such information and
6.53 Additional circumstances associated with public safety and security concerns could also justify the exclusion of certain information from a publicly available or widely distributed report. For example, detailed information related to computer security for a particular program may be excluded from publicly available reports because of the potential damage that could be caused by the misuse of this information. In such circumstances, auditors may issue a limited use report containing such information and distribute the report only to those parties responsible for acting on the auditors' recommendations. The auditors may consult with legal counsel regarding any requirements or other circumstances that may necessitate the omission of certain information.

6.54 Considering the broad public interest in the program or activity under review assists auditors when deciding whether to exclude certain information from publicly available reports. When circumstances call for omission of certain information, auditors should evaluate whether this omission could distort the engagement results or conceal improper or illegal practices.

6.55 When audit organizations are subject to public records laws, auditors should determine whether public records laws could impact the availability of classified or limited use reports and determine whether other means of communicating with management and those charged with governance would be more appropriate. For example, the auditors may communicate general information in a written report and communicate detailed information verbally. The auditor may consult with legal counsel regarding applicable public records laws.
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Distributing Reports

6.56 Distribution of reports completed under GAGAS depends on the relationship of the auditors to the entity and the nature of the information contained in the report. If the subject matter or the assertion involves material that is classified for security purposes or contains confidential or sensitive information, auditors may limit the report distribution. Auditors should document any limitation on report distribution. The following discussion outlines distribution for reports completed under GAGAS:

a. Audit organizations in government entities should distribute reports to those charged with governance, to the appropriate entity officials, and to the appropriate oversight bodies or organizations requiring or arranging for the engagements. As appropriate, auditors should also distribute copies of the reports to other officials who have legal oversight authority or who may be responsible for acting on engagement findings and recommendations, and to others authorized to receive such reports.

b. Internal audit organizations in government entities may follow the Institute of Internal Auditors (IIA) International Standards for the Professional Practice of Internal Auditing. Under GAGAS and IIA standards, the head of the internal audit organization should communicate results to the parties who can ensure that the results are given due consideration. If not otherwise mandated by statutory or regulatory requirements, prior to releasing results to parties outside the organization, the head of the internal audit organization should:
   (1) assess the potential risk to the organization,
   (2) consult with senior management and/or legal counsel as appropriate, and
   (3) control dissemination by indicating the intended users in the report.

c. Public accounting firms contracted to perform an engagement under GAGAS should clarify report
distribution responsibilities with the engaging organization. If the contracting firm is to make the distribution, it should reach agreement with the party contracting for the engagement about which officials or organizations will receive the report and the steps being taken to make the report available to the public.
Appendix B

Other Sources of Information

Other Guidance

A number of resources are available to assist the auditor in obtaining information related to economic, regulatory, and professional developments impacting audits of governmental and not-for-profit organizations. While not exhaustive by any means, auditors may find the following resources helpful in planning and performing audits of governmental and not-for-profit organizations.

**AICPA Accounting and Auditing Technical Hotline**

Members may inquire about accounting, auditing, attestation, compilation and review services using the Technical Hotline by calling 1-888-777-7077 or 1-877-242-7212.

**AICPA Audit and Accounting Guides & Risk Alerts**

Separate audit and accounting guides and risk alerts specific to audits of governmental and not-for-profit organizations are available through the AICPA. Obtain by calling the AICPA Order Department 1-888-777-7077 or through www.cpa2biz.com.

**AICPA Continuing Professional Education Courses**

A great number of continuing education courses are available through the AICPA in either group or self study formats. Information and ordering is available through www.aicpalearning.org.

**AICPA Ethics Hotline**

Member questions related to independence and other behavioral issues related to the AICPA Code of Professional Conduct may be directed to the Ethics Hotline. Members of the AICPA’s Professional Ethics Team may be contacted through the AICPA at 1-888-777-7077.

**Financial Accounting Standards Board Publications**

FASB publications are available directly from the FASB. Obtain by calling the FASB Order Department at 1-800-748-0659 or through the Internet at www.fasb.org.
Guide to Fraud in Governmental and Not-for-Profit Environments

Government Accountability Office Publications

Copies of GAO reports and testimony are available directly through the GAO at www.gao.gov.

Governmental Accounting Standards Board Publications

GASB publications are available directly from the GASB. Obtain by calling the GASB Order Department at 1-800-748-0659 or through the internet at www.gasb.org. Auditors may find the GASB Technical Bulletins issued periodically by the GASB staff helpful in understanding certain specific aspects of governmental accounting and financial reporting.

Government Finance Officers Association

Even though most GFOA publications are written primarily for government finance officers, auditors of governmental organizations may find them helpful. Inquiries may be made by phone (312) 977-9700, fax (312) 977-4806, or www.gfoa.org.

Helpful Web Sites

The Internet is an extremely efficient and effective way in which auditors may access additional information. However, there is a great deal of inconsistency in the reliability of information available through the Internet. Auditors should exercise caution when relying on information obtained through the Internet especially when the source is not well known to the auditor.

Again, the following list is not exhaustive by any means; however, auditors may find the following Internet resources helpful in audits of governmental and not-for-profit organizations.

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Governmental Terminology

**Capital Assets** – Capital assets include land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period.

**Fund Financial Statements** – The fund financial statements consist of a series of statements that focus on information about the government's major governmental and enterprise funds as well as its internal service and fiduciary fund types.

**GASB** – The Governmental Accounting Standards Board (GASB) was organized in 1984 by the Financial Accounting Foundation (FAF) to establish standards of financial accounting and reporting for state and local governmental entities. Its standards guide the preparation of external financial reports of those entities.

**General-Purpose Governments** – General-purpose governments are governmental entities that provide a range of services, such as states, cities, counties, towns, and villages.

**Government-Wide Financial Statements** – The government-wide financial statements are highly aggregated financial statements that present financial information for all assets (including infrastructure capital assets), liabilities, and net assets of a primary government and its component units, except for fiduciary funds. The government-wide financial statements use the economic resources measurement focus and accrual basis of accounting.

**Infrastructure Assets** – Infrastructure assets are long-lived capital assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Examples of infrastructure assets are roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems. Buildings, except those that are an ancillary part of a network of infrastructure assets, are not considered infrastructure assets.

**Major Funds** – A government’s general fund (or its equivalent), other individual governmental and enterprise funds that meet specific quantitative criteria, and any other governmental or enterprise fund that a government’s officials believe is particularly important to financial statement users.
Management's Discussion and Analysis (MD&A) – MD&A is RSI that introduces the basic financial statements by presenting certain financial information as well as management's analytical insights on that information.

Modified Approach – Rules that allow infrastructure assets that are part of a network or subsystem of a network not to be depreciated as long as certain requirements are met.

Required Supplementary Information (RSI) – GAAP specify that certain information be presented as RSI.

Special-Purpose Governments – Special-purpose governments are legally separate entities that perform only one activity or only a few activities, such as cemetery districts, school districts, colleges and universities, utilities, hospitals and other health care organizations, and public employee retirement systems.

Not-for-Profit Terminology

Charitable Lead Trust – A trust established in connection with a split-interest agreement, in which the not-for-profit organization receives distributions during the agreement's term. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to third-party beneficiaries designated by the donor.

Charitable Remainder Trust – A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives specified distributions during the agreement's term. Upon termination of the trust, a not-for-profit organization receives the assets remaining in the trust.

Collections – Works of art, historical treasures, or similar assets that are (a) held for public exhibition, education, or research in furtherance of public service rather than financial gain, (b) protected, kept unencumbered, cared for, and preserved, and (c) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

Conditional Promise to Give – A promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

Contribution – An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.
Costs of Joint Activities – Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as fund raising, program, management and general, and cost of sales.

Donor-Imposed Restriction – A donor stipulation that specifies a use for the contributed asset that is more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in its articles of incorporation or bylaws, or comparable documents for an unincorporated association. A restriction on an organization’s use of the asset contributed may be temporary or permanent.

Functional Classification – A method of grouping expenses according to the purpose for which the costs are incurred. The primary functional classifications are program services and supporting activities.

Joint Activity – A joint activity is an activity that is part of the fund-raising function and has elements of one or more other functions, such as programs, management and general, membership development, or any other functional category used by the entity.

Joint Costs – Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity.

Natural Expense Classification – A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, supplies, rent, and utilities.

Permanently Restricted Net Assets – The part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

Promise to Give – A written or oral agreement to contribute cash or other assets to another entity. A promise to give may be either conditional or unconditional.

Temporarily Restricted Net Assets – The part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by the passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.
Unrestricted Net Assets – The part of net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

Single Audit & Yellow Book Terminology

Attestation Engagements – Attestation engagements concern examining, reviewing, or performing agreed-upon procedures on a subject matter or an assertion about a subject matter and reporting on the results.

Compliance Supplement – A document issued annually in the Spring by the OMB to provide guidance to auditors.

Data Collection Form – A form submitted to the Federal Audit Clearinghouse which provides information about the auditor, the auditee and its Federal programs, and the results of the audit.

Federal Financial Assistance – Assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals in accordance with guidance issued by the Director.

Financial Audits – Financial audits are primarily concerned with providing reasonable assurance about whether financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) or with a comprehensive basis of accounting other than GAAP.

GAGAS – Generally Accepted Government Auditing Standards issued by the GAO. They are also commonly known as the Yellow Book.

GAO – The United States Government Accountability Office. Among their responsibilities is the issuance of Generally Accepted Government Auditing Standards (a.k.a. the Yellow Book).

OMB – The Office of Management and Budget. OMB assists the President in the development and implementation of budget, program, management, and regulatory policies.

Pass-Through Entity – A non-Federal entity that provides Federal awards to a subrecipient to carry out a Federal program.

Performance Audits – Performance audits entail an objective and systematic examination of evidence to provide an independent assessment of the performance and management of a program against objective criteria as well as assessments that provide a prospective focus or that synthesize information on best practices or cross-cutting issues.
**Program-Specific Audit** – An audit of one Federal program.

**Single Audit** – An audit of a non-Federal entity that includes the entity's financial statements and Federal awards.

**Single Audit Guide** – This AICPA Audit Guide formally titled *Government Auditing Standards and Circular A-133 Audits* (the Single Audit Guide) is the former Statement of Position (SOP) 98-3. The Single Audit Guide provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act and Circular A-133.

**Subrecipient** – A non-Federal entity that receives Federal awards through another non-Federal entity to carry out a Federal program, but does not include an individual who receives financial assistance through such awards.
Chapter 1

Solutions to Review Questions

1. The four major aspects are that governmental organizations
   - Are public organizations.
   - Provide goods and services to the general public using funds typically secured from involuntary resource providers.
   - Make decisions in a political environment.
   - Provide goods and services without regard to a profit motive.

2. The major differentiating aspects are that
   - Not-for-profit organizations receive significant contributions of resources from donors not expecting commensurate or proportionate financial return.
   - Not-for-profit organizations operate for purposes other than to provide goods or services at a profit.
   - Ownership interests are absent.

3. The primary users include
   - Citizens.
   - Legislative and oversight bodies.
   - Investors and creditors.

4. The primary users are
   - Resource providers.
   - Constituents.
   - Governing and oversight bodies.
Chapter 2

Solutions to Review Questions

1. Due to the nature of evidential matter obtained in an audit and the characteristics of fraud, it is not possible to obtain absolute assurance with respect to material misstatements in the financial statements.

2. The three sides are
   - Incentive or pressure.
   - Opportunity.
   - Rationalization or attitude.

3. Fraud is an intentional act while errors are not intentional.

4. Fraud is an intentional act resulting in a material misstatement in the financial statements arising from
   - Fraudulent financial reporting.
   - Misappropriation of assets.

5. Management is in a position to
   - Withhold evidence.
   - Misrepresent information in response to inquiries.
   - Falsify documents.

6. Professional skepticism is an attitude requiring the auditor to have a questioning mind and to critically assess audit evidence.

7. The four ways are
   - Inquiries of management and others regarding the risks of fraud.
   - Performance of analytical procedures as part of the audit planning process.
   - Consideration of fraud risk factors.
   - Consideration of other information helpful in identifying fraud risks.

8. The two additional areas are
   - Improper revenue recognition.
   - Risk of management override.

9. The three ways include
• A response having an overall effect on how the audit is conducted.

• A response to identified risks involving the nature, timing, and extent of planned auditing procedures.

• A response involving performing certain procedures to further address fraud risk due to management override.

10. Communication is required when there is evidence a fraud may exist. The levels of fraud and the levels to which it is communicated include

• Fraud involving senior management (regardless of materiality) – those charged with governance.

• Fraud causing a material misstatement in the financial statements (regardless of the level at which it was perpetrated) – those charged with governance.

• Fraud involving lower level employees – management at least one level above level of fraud.

• Significant deficiencies and material weaknesses relating to internal control – senior management and those charged with governance.

• Potential reporting outside the entity.

Solution to Case Example 2-1

1. Based on the facts above, what might concern Able, Best & Co. when applying the requirements of SAS No. 99 in the first year of the contract?

• Council perception that larger firms are better at finding fraud than smaller firms.

• Staffing the engagement with the personnel indicated in the proposal.

• Timing of the contract and its impact on audit planning including assessing potential fraud risks.

• What significant deficiencies the Director of Finance disagreed with and why.

• Related party transactions between the City and its component units due to the involvement of the Mayor and Council members.

2. What fraud risk factors might exist with respect to the concerns identified in Question 1?

• Longevity of Finance Department staff.

• Competence of Finance Department staff.

• Management override (by City Council or department directors).

• Too much control by Director of Finance (i.e., holding payment of prior year audit fee).

• Lack of controls due to limited Finance Department staff.
• Involvement of Mayor and Council members with component units.

3. What aspects of the fraud triangle should be considered in these circumstances?

• Opportunity – lack of staff in Finance Department, involvement of Mayor and Council members with the component units.
• Rationalization/attitude – improper transactions between the City and the component units due to involvement of the Mayor and other Council members.
• Incentive/pressure – Mayor and Council members associated with the component units.

Chapter 3

Solutions to Review Questions

1. For those auditors with long-term and/or close relationships with their governmental or not-for-profit clients, it may prove difficult to adopt the required level of professional skepticism. Even when auditors feel they have assumed the level of professional skepticism required by SAS No. 99, the “appearance” of professional skepticism may not be apparent to those outside the audit firm.

Long term auditor-client relationships and/or multi-year assignment of professional staff to a particular audit entity may give the auditor a false sense of security with respect to the organization under audit. In these situations (whether or not a long term relationship exists between the auditor and the organization), engagement and/or firm staff may believe client personnel to be honest and to act with integrity. Because it may be difficult for audit staff members to exercise appropriate professional skepticism in these circumstances, the engagement team should constantly strive to put aside past relationships with the organization.

2. The three steps are as follows:
   • The fraud is committed.
   • Perpetrators receive the benefits of the fraud.
   • The fraud is concealed.

3. Unique areas include
   • Significant contributions – Not-for-profit organizations often rely on contributions from individuals and businesses to fund the services they provide as part of their mission. Such contributions are often significant to the total resources available to the not-for-profit organization. Contributions or grant monies received by a not-for-profit organization may be subject to donor restrictions imposing time or use restrictions either on a temporary or permanent basis.
• **Lack of a profit motive** – Not-for-profit organizations are organized for and operated to achieve a particular mission rather than to make a profit from their operations.

• **Ownership interests** – Not-for-profit organizations do not have stockholders; therefore, the equity in the not-for-profit organization is represented by its net assets. Because there are no “owners” in a not-for-profit organization, no “owners” exist to protect the net assets of the not-for-profit organization.

• **Related party transactions** – Individuals are often selected to serve on the board of directors based on the financial or economic resources available to them in other capacities. Local independent not-for-profit organizations may also be affiliated with regional, national, or international not-for-profit organizations.

• **Functional allocation of expenses** – Not-for-profit voluntary health and welfare organizations report expenses by functional and natural classifications in a matrix format. Other not-for-profit organizations report expenses by functional classifications and are encouraged to provide information about their natural expense classification.

• **Internal accounting controls** – Lack of staff or the lack of qualified staff in administrative and/or accounting and finance functions results in improper segregation of duties, a high level of error in recording transactions, and missing or ineffective control systems.

• **Repeat significant deficiencies and other matters related to internal control** – A strong mindset toward providing services to achieve the mission of the organization at the expense of administrative support functions may exist. As a result, significant deficiencies may continue to exist for a number of years. This may also hold true for other matters related to internal control repeated from year to year.

• **Split-interest agreements** – Terms may be revocable by the donor in certain situations. These agreements may exist for either a finite number of years, in perpetuity, or for the remaining life of a specific individual.

4. Employees of governmental organizations are under constant pressure to provide more and/or higher quality services with fewer resources. When the economy is in decline, there is added pressure on governmental organizations to maintain current tax rates and user charges. This places pressure on the management of governmental organizations to meet or improve upon budgeted amounts. An incentive to overstate revenues or to understate expenses/expenditures may be created by this pressure.

5. The lack of personnel or the lack of sufficiently qualified personnel is prevalent in administrative and/or accounting and finance functions in governmental organizations. The resulting lack of, or ineffective, internal controls creates opportunities for fraud.

Governmental organizations often have a number of locations taking cash in payment of services such as recreation centers, police departments, libraries, etc. Lacking or ineffective controls create opportunities for fraud in these areas also. It is highly likely the amounts of many of these revenues are not material to the financial statements of the governmental organization taken as a whole. However, one of the objectives of financial reporting for
governmental organizations is public accountability. Situations such as these, while not material to the financial statements, are material to public accountability.

6. The overall response to judgments regarding the risk of material misstatements due to fraud affects audits of not-for-profit organizations in the following manner.

- **Assignment of personnel and supervision** – Because of limited qualified not-for-profit auditors, this could be difficult for the auditor.

- **Choice of accounting principles** – In light of the requirements of FASB Statements No. 116 and No. 117, the auditor will need to review a number of accounting choices made by their not-for-profit organization clients. Other FASB pronouncements also require the not-for-profit organization to make choices regarding the accounting for certain types of transactions.

- **Predictability of auditing procedures** – This is especially difficult when a long term client relationship exists. Additionally, it may be exacerbated if there are long-term employees within the not-for-profit organization, especially in the accounting or finance areas.

7. Because of the large number of grants or other intergovernmental revenues common to most governmental organizations, **revenue recognition** may be of particular concern to the auditor with respect to the consideration of fraud. The concern here is more with misstatements due to fraudulent financial reporting than misappropriation of assets. Generally accepted accounting principles related to recording exchange and non-exchange transactions contribute to the issue of proper revenue recognition in governmental organizations.

However, it is possible that in some governments revenue recognition may not be a fraud risk area from the perspective of misappropriation of assets. In some localities, all material revenues are received via electronic funds transfers or checks on a periodic basis from another governmental agency. This holds true for municipal property taxes in a number of states where the county acts as the tax assessor and collector for all taxing authorities within its jurisdiction. For many governments, revenues received in cash or at offsite locations with few internal controls are often immaterial to the financial statements taken as a whole.

8. Examples include

- Allowances for material uncollectible receivables such as pledges, special assessments, dues, and customer receivables.

- Split-interest agreements.

- Estimated useful lives of capital assets.

- Estimates of accrued compensated absences.

- Estimated contingent liabilities for litigation, claims, and assessments.

- Allocation of joint costs.

- Functional allocations of expenses.
9. Examples include

- **Economic development incentives** – Who ultimately benefits, were multi-year projections used in the decision process, were multi-year projections discounted to present value, were discount rates reasonable, were grant funds involved, was the transaction predicated on performance objectives, was the transaction arm’s-length?

- **Onerous provisions in union contracts** – What negative impacts will be felt in other areas, will this lead to other unions having the same expectations, why were the concessions necessary?

- **Real estate purchases or sales** – Were permanent assets sold and if so, why, what is the intended use for the proceeds of the sale, what is the intended use of the real estate purchased, are environmental liabilities assumed/transferred, was the real estate sold purchased in whole or in part with grant funds, was the transaction arm’s-length?

- **Land swaps** – What was the use of the land given up, what is the intended use of the land received, are environmental liabilities assumed/transferred, was the real estate sold purchased in whole or in part with grant funds, was the transaction arm’s-length?

- **Granting of easements** – What was the business purpose, was it an exchange transaction and if not why, was the transaction arm’s-length?

- **Public/private partnerships** – Who ultimately benefits, were multi-year projections used in the decision process, were multi-year projections discounted to present value, were discount rates reasonable, was the transaction predicated on performance objectives, was the transaction arm’s-length?

- **Privatizing of governmental services** – Who ultimately benefits, were multi-year projections used in the decision process, were multi-year projections discounted to present value, were discount rates reasonable, were government owned capital assets transferred to the new service provider and if so were any purchased with grant funds, was the transaction predicated on performance objectives, will service levels improve or remain unchanged, does the transaction make business sense, was the transaction arm’s-length?

- **Early extinguishment of debt** – Was an economic benefit received, what benefit was received if no economic benefit was received, was the transaction arm’s-length?

10. Possible reasons include

- Faith based attitudes regarding potential fraud.

- General feeling that all people are “good” and not capable of intentionally causing harm to others.

- Fear of alienating current and future donors.

- Belief that others will see the organization as being easily duped.

- Suspected employees may be long-term employees.
• Management feels “guilty” for allowing an environment conducive to fraud.
• Amounts are considered small or the perpetrator was “justified” in misappropriating organizational assets.

Solution to Case Example 3-1

1. Based on the facts above, what fraud risk factors might exist related to management override, accounting estimates and revenue recognition?

   • Management override
     – Lack of experienced Finance Director creates opportunity for City Manager and other department directors to override controls.
     – City Manager has an incentive to perform well in order to save her job and/or receive a performance bonus. This, coupled with a weak Finance Director and limited finance function, creates a potential fraud risk.

   • Accounting estimates
     – City Manager does not have an accounting/finance background and is therefore unlikely to understand accounting estimates or their underlying rationale.
     – Turnover in the Finance Director position creates lack of continuity, and accounting estimates may have been ignored or not updated periodically.
     – Lack of expertise in the Finance Director position may result in inaccurate accounting estimates or weak underlying rationale.

   • Revenue recognition
     – City Manager has an incentive to overstate revenues since that is one component of her performance bonus.
     – The Finance Director is inexperienced and may not recognize revenue recognition issues.
     – Two out of three elected officials are up for re-election and one is a lame duck. This may provide them an incentive to create a healthy financial picture when it does not exist.

2. What specific preliminary procedures should be performed to address the fraud risks identified in Question 1?

   • Inquiries of City Manager, Finance Director, City Council, and other department directors related to their awareness and understanding of fraud and fraud risks as well as procedures in place to prevent, detect, and deter it.
   • Extend inquiries to other departments and locations talking to operating as well as administrative personnel.
   • Review all responses with a high degree of professional skepticism.
• Extend preliminary analytical procedures and thoroughly review responses from client personnel as to reasons for fluctuations, differences, or issues not in line with expectations.

• Hold frequent discussions among engagement personnel regarding findings, etc.

3. What aspects of the fraud triangle should be considered in these circumstances?

• Incentive/Pressure
  – City Manager can be fired without cause and the contract is renewable annually at the discretion of the City Council.
  – City Manager has a performance clause in her contract.
  – Budget constraints exist.
  – The Mayor and Councilman III are running for re-election.
  – Pay scales are low and expectations are high.

• Opportunity
  – Finance Director is new in position and has limited experience. Therefore, he may not realize internal controls are missing or that existing controls may not be effective.
  – Administrative support positions are limited.
  – Finance Department staff is limited.

• Rationalization/Attitudes
  – Low pay scales may create rationalization of fraud.
  – Lack of controls may create attitude that no one cares if fraud occurs.
  – Pressure for the City Manager to perform may result in rationalization of fraudulent financial reporting.
  – Finance Director’s limited experience may create attitude that he does not know what he is doing.
  – Finance Director’s limited experience may make him feel inadequate and therefore subject to management override.

Solution to Case Example 3-2

1. Based on the facts above, what fraud risk factors might exist related to management override, accounting estimates and revenue recognition?

• Management override
  – CEO recommends new Board members for Executive Committee review.
– CEO hired the CFO for reasons that may be suspect.
– CEO sits on the Executive Committee which executes the engagement letter and also sits as the *de facto* finance and audit committees.
– Branch Managers are autonomous and not subject to many internal controls.

• **Accounting estimates**
  – CEO is familiar with the organization since he came up through the ranks.
  – CEO hired the CFO.

• **Revenue recognition**
  – Top leadership and management at Administrative and Branch locations may receive performance-based bonuses. This incentive may lead to fraudulent financial reporting at a number of levels.

2. **What specific preliminary procedures should be performed to address the fraud risks identified in Question 1?**

• Inquiries of CEO, CFO, Executive Committee members, and Branch Managers related to their awareness and understanding of fraud and fraud risks as well as procedures in place to prevent, detect, and deter it.

• Extend inquiries to other Administrative Office and branch operating as well as administrative personnel.

• Review all responses with a high degree of professional skepticism. This may be difficult due to the long tenure of the audit relationship and due to the year-to-year nature of the engagement.

• Extend preliminary analytical procedures and thoroughly review responses from client personnel as to reasons for fluctuations, differences, or issues not in line with expectations.

• Hold frequent discussions among engagement personnel regarding findings, etc., and encourage a high degree of professional skepticism among them. This may be difficult again due to tenure and uncertainty of a continuing engagement.

3. **What aspects of the fraud triangle should be considered in these circumstances?**

• **Incentive/Pressure**
  – Other than leadership and top management, pay scales are low and expectations are high.
  – Leadership and management personnel may receive a bonus based on performance.
  – The CFO may succumb to pressure rather than being demoted as was his predecessor.
• **Opportunity**
  – Branch personnel operate relatively autonomous from the Administrative Office and what little oversight exists relates more to operations.
  – Lack of personnel and improper segregation of duties at branch locations.
  – Bank statements are not reconciled timely indicating a long lag may exist before defalcations are discovered.

• **Rationalization/Attitudes**
  – Low pay scales may create rationalization of fraud.
  – Lack of controls may create attitude that no one cares if fraud occurs.
  – Pressure for the leadership and management to perform may result in rationalization of fraudulent financial reporting.
  – CEO attitude regarding the lack of urgency associated with addressing prior year significant deficiencies.
  – CFO may be concerned with job security due to circumstances surrounding the demotion of the former CFO.

### Chapter 4

#### Solution to Case Example 4-1

1. Based on the facts above, what issues and concerns exist with respect to revenue recognition in the water/sewer utility? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to fraudulent revenue recognition?

Excess capacity in the water/sewer system has resulted from expansion of the system and no corresponding growth in the customer base primarily because of the sluggish economy. If performance requirements and/or coverage ratios are required under the bond covenants (new or old issues), this situation creates an incentive for management to possibly misstate certain amounts in the financial statements in order to meet these debt-related covenants. Because of the potential for management override (see solutions for Chapter 4), this may be of even greater concern to the auditor. Audit procedures would include

- Review of bond covenants to determine requirements under the covenants.
- Lower threshold for procedures related to the search for unrecorded liabilities.
- Analytical procedures including current year analysis and comparison to prior year activity/amounts:
  – Calculate average revenue by customer type or service area.
  – Calculate average gallons billed by customer type or service area.
– Calculate ratio of gallons pumped to gallons billed.
– Comparison of gallons pumped/billed per internal records to those reported to environmental regulatory agencies.
– Review of useful lives and depreciation methods for consistency with previously recorded assets and industry guidelines.
– Review of entries to general ledger accounts.
– Review of significant customer adjustments.
– Determine whether interfund transfers in/out are consistent with operations and/or financial statement amounts.
– Monthly analysis if warranted based on above procedures performed using annual amounts.

2. Based on the facts above, what issues and concerns exist with respect to accounting estimates? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to fraudulent accounting estimates?

It does not appear that a concern regarding accounting estimates related to the water/sewer system and transportation improvements are of particular concern from a fraud perspective.

• The auditor would perform procedures to provide assurance as to the technical competence and professional reputation of the two engineering firms.

• Additionally, the auditor would want to determine that the lives and condition assessments determined by the engineering firms are properly reflected in the books and records of the City for financial reporting purposes.

3. Based on the facts above, what issues and concerns exist with respect to functional and/or fund classifications for the golf course? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to fraudulent functional and/or fund classifications?

Proper accounting and reporting of the golf course operations may be an audit concern with respect to fraudulent functional and/or fund classifications.

Audit procedures might include the following:

• During audit planning, determine how net losses have been reflected and if management expects the trend to continue. Additionally, ascertain what actions management intends to take in order to address the net loss situation.

• If net losses are not recorded/reported, the auditor might perform the following procedures:
  – Calculate average revenue per guest.
– Ascertain all expenses allocated in previous years have been allocated in the current year and in the proper and consistent proportions.
– Determine the consistency of the fund classification and the activity type.
– Review depreciation schedules for consistency of lives and methods with respect to assets on hand at the beginning of the year and acquired during the current year.
– Review of additions to fixed assets for propriety and consistency of long-term classification.
– Lower threshold for procedures related to the search for unrecorded liabilities.
– Observe physical inventory and perform related procedures.
– Compare year end inventory levels for consistency with recorded year end inventory activity.
– Review of entries to general ledger accounts.
– Review of significant customer adjustments.
– Determine whether interfund transfers in/out are consistent with operations and/or financial statement amounts.

Solution to Case Example 4-2

1. Based on the facts above, what issues and concerns exist with respect to revenue recognition? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to fraudulent revenue recognition?

Salaries and benefits recorded as reimbursable under the grant are not revenue in the year under audit. Audit procedures to determine the improper revenue recognition might include

- Confirmation of receivables.
- Confirmation of key terms of significant grant agreements.
- Analytical review of salaries and benefits by branch and by program.
- Comparison of revenues by sources to that of prior year.
- Review of net operating results by branch and comparison to prior year and to budgeted amounts.

2. Based on the facts above, what issues and concerns exist with respect to accounting estimates? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to fraudulent accounting estimates?

The change in the allowance from 30% to 5% may indicate fraudulent financial reporting due to accounting estimates.

Audit procedures to determine if this has occurred might include the following:
Inquiry of management as well as accounting/finance personnel regarding changes in estimates and why.

Calculate average write off per donor and compare to prior year.

Calculate average net receivable and compare to prior year.

Perform procedures to test the aging of receivables and compare this to prior years.

3. Based on the facts above, what issues and concerns exist with respect to functional and/or fund classifications? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to fraudulent functional and/or fund classifications?

   - A portion of the salaries and benefits of branch personnel appear to be fund raising expenses.
   - Review of the minutes of the Board meetings should indicate when the annual fund raising campaign kicks off. Additionally, the auditor should obtain any literature associated with mass mailings and/or fund raising activities.
   - Auditors should inquire of management and branch personnel as to what they do and for how long. This should be updated each year.
   - Review of amounts charged to fundraising should include salaries and benefits related to at least some employees in all not-for-profit organizations. The expected amounts and transactions will be unique to each organization.

Chapter 5

Solution to Case Example 5-1

1. Based on the facts above, what issues and concerns exist with respect to procurement and contracting? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to assets misappropriated through procurement and/or contracting fraud?

   - As indicated in the solutions for Chapter 3, the potential for fraud from management override exists. Therefore, audit procedures related to procurement and contracting should address this potential fraud area.
   - Inquiry of the Finance Director and accounts payable personnel as to any purchasing “issues.”
   - Inquiry of the Finance Director and accounts payable personnel as to any “habitual offenders” related to procurement/contracting.
   - Audit procedures might include
     - Review of vendor activity by purchase order and determining compliance with all applicable procurement/contracting requirements.
2. Based on the facts above, what issues and concerns exist with respect to cash receipts and disbursements? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to misappropriated cash receipts or misdirected cash disbursements?

Actions of the Supervisor of Water Operations give the secretary access to the Procurement Card number. With this number, the secretary can make any number of transactions over the phone or using the Internet. This would be an even greater risk if the secretary is aware of the security limits placed on the card.

Audit procedures might include

- Review of purchases by establishment and/or type of establishment for consistency with employee positions/functions.
- Review of transaction activity by employee by month.
- Ascertain types of purchases by card (i.e., point of sale, phone, Internet).
- Comparison of “ordered by,” “received by,” etc., with card holder.

3. Based on the facts above, what issues and concerns exist with respect to personnel costs? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to assets misappropriated through fraudulent personnel transactions?

- This is an area of potential abuse. In many cases, additional appropriations may be made to increase overtime within certain functions (especially public safety).
- For this particular situation, a review of W-2 earnings by employee might indicate lower level employees with higher annual wages than supervisors and managers.
- Additional procedures might include
  - Calculating annual overtime per employee amount and comparing it to prior years and other departments.
  - Calculating annual sick time and/or vacation days per employee and comparing it to prior years and other departments.
  - Comparing ratio of overtime to regular salaries by function, department, division or some other appropriate classification and determining consistency with prior years and other departments.
  - Reviewing number of sick and vacation days by employee, function, department, division or some other appropriate classification to determine if excessive hours have been taken.
4. Based on the facts above, what issues and concerns exist with respect to property, plant, and equipment? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to misappropriated property, plant, and equipment?

This is another area of abuse (citizens expect their governments to account for all physical assets) as well as a violation of law. In addition, not accounting for physical assets costing less than $5,000 puts them at risk of misappropriation.

Audit procedures would include

- Inquiry of appropriate personnel as to City policies and comparison to laws, rules, regulations, etc.
- Review of supplies (or other appropriate account) accounts for items costing more than $1,000 and then determining the physical location of such items.

5. Based on the facts above, what issues and concerns exist with respect to diversion of program benefits and/or assets? What audit procedures might provide assurance that the City’s financial statements are not materially misstated due to diverted program benefits and/or assets?

Because one City employee is responsible for safekeeping and distributing rent vouchers the potential for the diversion of program assets exists. Audit procedures might include

- Reading minutes of Council meetings to determine the approval of interlocal agreements.
- Obtaining all interlocal agreements, reviewing their terms, and determining appropriate fraud risk areas.
- Inquiring of appropriate personnel as to the programs offered, their benefits, and the administration of the program.
- Various substantive testing relating to the distributions. Consideration of confirmations.

Solution to Case Example 5-2

1. Based on the facts above, what issues and concerns exist with respect to procurement and contracting? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to assets misappropriated through procurement and/or contracting fraud?

- The lack of central controls over branch operating type purchasing and contracting should be a significant concern for the auditor. It appears it will be necessary to ascertain the procedures at each branch and to assess them from an internal control perspective.
• The lack of formal written policies related to construction contracts, long-term financing, and banking services should also be of significant concern to the auditor.

• Centrally-administered procedures related to construction contracts, long-term financing, and banking services would need to be reviewed to determine if they are arm’s length.

• Additionally, transactions would need to also be reviewed with respect to a bona fide business purpose.

2. Based on the facts above, what issues and concerns exist with respect to cash receipts and disbursements? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to misappropriated cash receipts or misdirected cash disbursements?

See answers to question number 1 above.

3. Based on the facts above, what issues and concerns exist with respect to personnel costs? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to assets misappropriated through fraudulent personnel transactions?

It appears no internal controls exist to protect against payroll fraud (branch managers hire and process all paperwork and payroll clerk enters personnel information and processes payroll).

Audit procedures might include

• Conducting simultaneous surprise payroll inspections during the year at branches with significant payroll activity.

• Analytical procedures such as
  – Calculating ratio of salaries and benefits to total branch expenses and comparing prior year and to other branches (may wish to do this by function/program within branch).
  – Determining number of employees by location (and/or by function/program) and comparing to prior year, other branches, and budget.

4. Based on the facts above, what issues and concerns exist with respect to property, plant, and equipment? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to misappropriated property, plant, and equipment?

• Adequate controls do not exist over physical assets to safeguard them from misappropriation.

• Adequate controls do not exist over donated physical assets to safeguard them from misappropriation.
• Audit procedures might include
  – Physical observation of significant physical assets from both records (accounting and insurance schedules) and from physical observation.
  – Review of supplies (or other appropriate accounts) for items costing more than $1,000 (or some other amount) and then determining the physical location of such items.

5. Based on the facts above, what issues and concerns exist with respect to diversion of program benefits and/or assets? What audit procedures might provide assurance that the financial statements for Healthy Families are not materially misstated due to diverted program benefits and/or assets?

This could be an area where program benefits/assets might be diverted. This issue also deals with accountability for donated resources.

Audit procedures might include
  • Inquiry of branch personnel as to solicitation activities and overall procedures.
  • Review of promotional literature prepared by branch personnel.
  • Confirmations.

**Chapter 6**

**Solutions to Review Questions**

1. Generally accepted government auditing standards (GAGAS) are followed by auditors when they are required to do so by
  – Law.
  – Regulation.
  – Grant agreement.
  – Contract.
  – Policy.

2. According to the Yellow Book, abuse is not the same as fraud, illegal acts, or violations of contract provisions or grant agreements. As defined by Section 4.12 of the Yellow Book:

   “…abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances.”

3. In a Yellow Book financial statement audit, common areas where instances of abuse might occur include
• Travel expenditures/expenses – First class airfare, meeting locations chosen for personal reasons rather than less costly locations, driving a personal vehicle and being reimbursed for mileage when less expensive transportation alternatives, exist, etc.

• Excessive and/or personal use of cellular phones – Calls to a facility placed soon after leaving it, calls made of a personal nature or during business hours, etc.

• Personal use of assets owned by the governmental or not-for-profit organization – Use of organization owned vehicles for personal errands, maintenance of personal files on computers owned by the organization, etc.

4. Typical duties of an effective audit committee should include

• Choosing the independent auditor.

• Reviewing the audit.

• Considering the report on internal control weaknesses.

• Reviewing the work of the internal audit function.

• Reviewing year-end and interim financial statements.

• Reviewing and approving changes in accounting principles.

• Considering and evaluating non-audit services performed by the external auditor.

• Preparing reports to the governing body or board of directors of all actions and recommendations taken by the audit committee.