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Governmental Auditing

A Comparison of the 1988 and the 1981 Revisions of "Government Auditing Standards: Standards for Audit of Governmental Organizations, Programs, Activities, and Functions"

By Lela D. Pumphrey and Karen Sparks

"The past three decades have seen a substantial increase in the number and dollar amounts of government programs and services ... " [GAO, 1988, p. i] With this increase in government expenditures came an increased demand for audit services to insure accountability by those responsible for managing government services and programs. In 1972, to provide guidance for auditors, the General Accounting Office (GAO) issued "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions." This publication (commonly referred to as the "Yellow Book") proved very useful and was revised in 1974 and again in 1981 in response to the needs of a dynamic auditing environment. In 1988 the standards were revised extensively and released with a slightly different title "Government Auditing Standards: Standards for Audit of Governmental Organizations, Programs, Activities, and Functions." The new standards are effective for audits starting January 1, 1989. This paper will list the most significant changes to generally accepted government auditing standards (GAGAS) and explain their implications for public accountants.

Summary of Important Revisions

The major revisions to the Yellow Book were incorporated into GAGAS in order to expand and clarify the existing standards, to provide guidance to auditors regarding their responsibility in connection with audits of government funds and to add a requirement for quality control. The major changes to the standards are listed in Table 1 and contrasted to the previous standards. A detailed discussion of each major change follows Table 1.

Quality Control

Perhaps the most significant change in GAGAS is the addition of a new quality control standard. This standard places responsibility on audit organizations that conduct "government audits to have an appropriate internal quality control system in place and to participate in an external quality control review program." [GAO, 1988, ¶ 3.44] The

purpose of the internal quality control system should be to provide reasonable assurance that the organization is following adequate audit policies and applicable auditing standards. The standards also require that an external quality control review be conducted at least once every 3 years. [GAO, 1988 ¶ 3.46] This new standard attempts to ensure the integrity of audits of state and local governments and non-government entities that receive government funds.

For public accountants who are members of the American Institute of Certified Public Accountants (AICPA) the new GAGAS requirement for an external quality review can be met simultaneously with meeting the new AICPA requirement for participating in quality review as a condition for membership. Public availability of the quality control report is not required by the AICPA and would therefore be an additional requirement.

Continuing Professional Education

Another significant change in GAGAS is the continuing education requirement.

The 1981 Yellow Book contained no guidance as to maintaining specific levels of proficiency. In contrast, the 1988 revision lists specific continuing education and training requirements which must be met by all auditors responsible for "planning, directing, conducting or reporting" [GAO, 1988, ¶ 3.7] on government audits. In addition to meeting the following require-

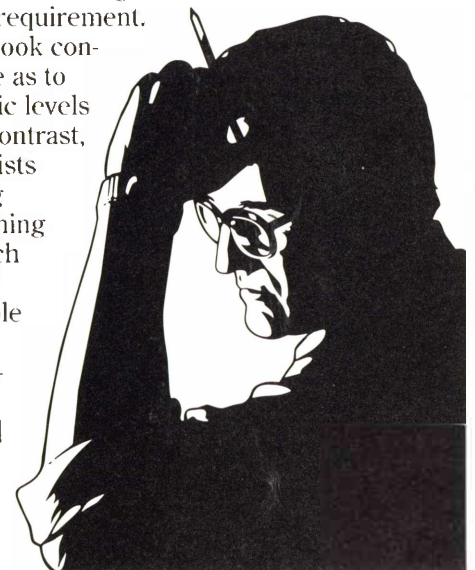


TABLE I*A Comparison of the 1988 and the 1981 Revisions of "Government Auditing Standards: Standards for Audit of Governmental Organizations, Programs, Activities, and Functions"*

1988: Requires an internal quality control system and an external quality control review (par. 3.43-3.48)	1981: Requires auditor to review general and application controls (page 40)
1981: No mention	1988: Changes terminology from "audit scope" to "types of audits" and classifies audits as financial or performance (par. 2.2)
1988: Specifies requirements for continuing professional education and training (par. 3.6-3.9)	1981: Identifies three scopes of audits: financial and compliance; economy and efficiency; and program results (page 12)
1981: No mention	1988: Requires a written report on the auditor's understanding of the entity's internal control structure and the assessment of control risk (par. 5.17)
1988: Requires auditors to design tests and procedures to detect errors, irregularities, and illegal acts (par. 4.13-4.18)	1981: Requires a report on the study and evaluation of internal control (page 29)
1981: Requires auditors to be alert to indications of fraud abuse and illegal acts (pages 26 and 47)	1988: Expands consideration of independence to include personal and external impairments (par. 3.15)
1988: Expands requirements for arrangement and content of working papers (par. 4.22)	1981: Accepts, for public accountants, the AICPA's definition of independence (page 18)
1981: Provides guidance for arrangement and content of working papers (page 46)	1988: Provides guidance on procuring audit services (par. 1.17)
1988: Requires follow-up on previous findings and requires disclosure of known but uncorrected material findings (par. 3.41)	1981: No mention
1981: Requires follow-up on findings from previous audits to determine actions taken (page 22)	1988: Refers to the Single Audit Act of 1984 (pages 1-5, 4-2, 4-3, 4-4, 5-2, 5-3, 5-11)
1988: Expands guidance on relying on the work of others (par. 3.35-3.40)	1981: No mention of Single Audit Act
1981: Requires relying on work of others when feasible (pages 35-36)	1988: Lists legislation which requires the use of these standards (par. 1.1-1.7)
1988: Expands guidance on materiality (par. 3.33-3.34)	1981: Recommends use of these standards by state and local auditors and public accountants auditing state and local entities (page 1)
1981: Mentions materiality (pages 21-22)	
1988: For computer-based systems permits either (a) a review of general and application controls or (b) other tests (par. 6.62)	

ments, the audit organization is required to maintain documentation of the education and training completed. [GAO, 1988, ¶ 3.7]

... auditors responsible for planning, directing, conducting, or reporting on government audits should complete, every 2 years, at least 80 hours of continuing education and training which contributes to the auditor's professional proficiency. At least 20 hours should be completed in any one year of the 2 year period. Individuals responsible for planning, directing, conducting substantial portions of the field work, or reporting on the government audit should complete at least 24 of the 80 hours of continuing education and training in subjects directly related to the government environment and to government auditing. [GAO, 1988, ¶ 3.6]

Errors, Irregularities, and Illegal Acts

The auditor's role in detecting and reporting errors irregularities, abuse and illegal acts represents a major change from 1981. The 1981 Yellow Book merely required the auditor to *be alert* to any situations, transactions, or events that could be indica-

tive of fraud, abuse, or illegal acts. [GAO, 1981, pp. 27 & 47]

Effective with the 1988 revision, however, an auditor "should *design steps and procedures* to provide reasonable assurance of detecting errors, irregularities and illegal acts that could have a direct and material effect on the financial statement or the results of financial related audits. [GAO, 1988, ¶ 4.13] Additionally auditors should "be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or the results of financial related audits." [GAO, 1988, ¶ 4.13] The field work standards for financial audits specify that in fulfilling the above requirement, the auditor should follow the guidance contained in the AICPA's Statements on Auditing Standards (SAS) #53 and #54.

An auditor conducting performance audits "should design the audit to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objectives." [GAO, 1988, ¶ 6.37]

Working Papers

The newest revision of the GAO standards expands the requirements for the arrangement and content of working papers. The 1981 Yellow Book specified that working papers: (1) contain the results and scope of the examination; (2) not require detailed, supplementary, oral explanations; (3) be legible; and (4) restrict information included to matters that are materially important and relevant to the objectives of the examination. [GAO, 1988, p. 46] In addition to these requirements, the 1988 Yellow Book requires that working papers: (1) contain a written audit program cross-referenced to the working papers; (2) contain the objectives and methodology of the audit; (3) contain adequate indexing and cross-referencing, and include summaries and lead schedules, as appropriate; and (4) contain evidence of supervisory reviews of the work conducted. [GAO, 1988, ¶ 4.22]

Audit Follow Up

As stated in the 1981 Yellow Book, due professional care requires the auditor to follow up on findings from previous audits to determine whether appropriate corrective actions have been taken. [GAO, 1981, p. 22] The 1988 Yellow Book expands on this requirement by requiring that government auditors have procedures to track the status of actions on material findings and recommendations and specifying that the auditor's report disclose the status of known uncorrected significant findings and recommendations from prior audits. [GAO, 1988, ¶ 3.41]

Public accountants unfamiliar with government auditing may not recognize their responsibilities in the area of audit follow-up. Implementing procedures to track the status of actions on material findings and recommendations may be as simple as an audit step in which all prior findings and recommendations are listed and a note made as to their disposition. Any prior findings and/or recommendations on which corrective action has not been taken would then be noted for disclosure in the current report.

Reliance on the Work of Others

The 1988 Yellow Book also includes guidance on relying on the work of others in order to increase audit efficiency by eliminating duplication of effort. The new standards contain specific guidance on the tests to be done before relying on the work of others. Tests of the quality of the work of other auditors will differ depending on whether the other auditors are external auditors, internal auditors, or nonauditors (specialists, experts, etc.). In all cases "the auditors should determine whether the audit organizations have an appropriate internal quality control system in place and whether the organization participates in an external quality review program." [GAO, 1988, ¶ 3.37(d)]

External Auditors

When the other auditors are external auditors, tests should include "making inquiries into the professional reputation, qualifications, and independence of the

auditors." [GAO, 1988, ¶ 3.37(a)] In addition, the auditor should consider reviewing the audit programs and/or work papers of the external auditors. [GAO, 1988, ¶ 3.37(a)]

Internal Auditors

When the other auditors are internal auditors, tests should include determining whether they are qualified and organizationally independent, as well as determining the quality of their work. [GAO, 1988, ¶ 3.37(b)]

Nonauditors

When the work has been performed by nonauditors, the auditors should "satisfy themselves as to the nonauditors professional reputation, qualifications, and independence." [GAO, 1988, ¶ 3.37(c)]

For public accountants following the auditing standards issued by the AICPA, there already exists a requirement to determine the independence and quality of work of other auditors before relying on their work. What is significantly different in auditing governmental entities is that such reliance is expected to avoid duplication of efforts.

Materiality

Materiality is another area that has been expanded by and clarified in the 1988 Yellow Book. The 1981 Yellow Book mentioned materiality in connection with the exercise of due professional care and stated that "...[A]s a minimum the choice of tests and procedures requires consideration of ... materiality of matters to which the test procedures will be applied ..." [GAO, 1988, pp. 21-22] In contrast to this brief mention of materiality and significance, the revised edition contains a lengthy discussion of this topic and enumerates various considerations, both qualitative and quantitative, that should be taken into account when attempting to determine materiality and audit risk. Public accountants should be aware that "[i]n government audits the materiality level and/or threshold of acceptable risk may be lower than in similar-type audits in the private sector ..." [GAO, 1988, ¶ 3.33] Because of the use of nonvoluntary resources (taxes) by government entities, the public has a

different expectation of the level of accountability that it has for private sector enterprises. Public accountants must take this lower materiality level into consideration in the planning stages when determining the tolerable error and in evaluation stage when deciding if the internal control reduces risk to an acceptable level or if the financial statements are presented fairly.

Reliance on a Computer-Based System

Since the computer had become an integral part of modern accounting systems, the 1981 Yellow Book included auditing computer-based systems as a separate standard in Chapter VI, "Examination and Evaluation Standards for Economy and Efficiency Audits and Program Results Audits." In the 1988 revision auditing computer-based systems was eliminated as a separate standard and incorporated under the "Evidence" standard for performance audits. The 1981 standards required the auditor to review both general controls and applications controls of data processing applications upon which the auditor was relying [GAO, 1981, p. 40], whereas 1988 revision allows the auditor a choice between reviewing general and application controls or performing other tests and procedures as the situation warrants in order to determine the reliability of data generated. [GAO, 1988, ¶ 6.62] This new wording allows the public accountant additional flexibility and permits the exercise of professional judgment when attempting to determine the reliability of computer generated data.

Types of Audits

There are several types of government audits. In the 1981 Yellow Book, the discussion of the types of audits appeared under the topic "scope of audit work" which consisted of Financial and Compliance audits, Economy and Efficiency audits, and Program Results audits. The 1988 revision not only changes the terminology from "scope" to "types" but also classifies audits in two categories – financial and performance. It also clearly states that "... [t]his description is not

intended to limit or require the types of audits that may be conducted or arranged." [GAO, 1988, ¶2.1] The revised standards emphasize that the audit objectives determine the type of audit to be conducted and the appropriate standards to be followed.

Understanding, Assessing, and Reporting on Internal Control

Internal control is the underlying basis of any accounting system. Therefore, both GAAS and GAGAS require that the auditor obtain "A sufficient understanding of the internal control structure ... to plan the audit and to determine the nature, timing and extent of tests to be performed." [GAO, 1988, ¶4.23] The 1988 revision clarifies the auditor's responsibility for understanding, assessing and reporting on internal control. In fulfilling this requirement, the revision specifies that the auditor should follow, at a minimum, the guidance contained in the AICPA's SAS #55. [GAO, 1988, ¶4.27]

Independence

The 1981 standards said that "public accountants will be considered independent if they are independent under the AICPA Code of Professional Ethics." [GAO, 1981, p. 18] this blanket acceptance of the Code of Professional Ethics (now titled the Code of Professional Conduct) of the AICPA does not appear in the 1988 revision. Rather, the new standards say that in addition to following the AICPA Code and the code of professional conduct of the appropriate state board of accountancy, public accountants need to consider those personal and external impairments that might affect their work and their ability to report their findings impartially. Two of the personal impairments which are not specifically addressed by the AICPA Code but which would impair independence under the GAO standards are: (1) "preconceived ideas toward individuals, groups, organizations, or objectives of a particular program [GAO, 1988, ¶3.16(b)]; and (2) "biases, including those induced by political or social convictions." [GAO, 1988, ¶3.16(d)]

Audit Procurement

Procurement of audit services is addressed in the 1988 Yellow Book. While not an audit standard, it is important that sound procurement practices be followed when contracting for audit services. " Specific factors to consider when awarding a contract are: "(a) price; (b) responsiveness of the bidder to the request for proposal; (c) past experience of the bidder; (d) availability of bidder's staff with qualification and technical abilities; (e) whether the bidder participates in an external quality control review program." [GAO, 1988, ¶1.17]

Public accountants should be aware of the factors which will be used to evaluate their proposal (bid). All of these factors, except item (b), can and should be addressed by the public accountants in the proposal.

Single Audit Act

Included in the 1988 Yellow Book are numerous references to the Single Audit Act of 1984 (the Act). Although the revised standards themselves do not include the requirements of the Act, various footnote references to those requirements are included where appropriate. The revised standards emphasize that in order to be in compliance with the Act, audits of state and local governments must be made in accordance with the standards set forth in the 1988 Yellow Book as well as the specific audit requirements of the Act that exceed the minimum audit requirements defined in the 1988 Yellow Book.

Public accountants accepting engagements to audit entities receiving federal financial assistance should be aware of the additional audit requirements of the Single Audit Act of 1984, OMB Circular A-128 and the AICPA publication *Audits of State and Local Government Units*. The Single Audit Act requires the public accountant to report on compliance for each major federal assistance program. This is a major expansion of testing and reporting requirements under GAAS.

Authority of GAGAS

In 1981 the standards were *required* for Federal auditors for audits of Federal organizations and non-Federal organizations receiving

Federal funds and were *recommended* for use by state and local government auditors and public accountants for audits of state and local organizations. [GAO, 1981, p. 1] Under various federal legislation, federal inspectors general and other federal auditors are required to use these standards. Under the Single Audit Act of 1984, the 1988 standards are *required* for any auditors conducting audits of state and local government organizations receiving federal financial assistance. [GAO, 1988, ¶1.4] Because almost all state and local entities receive some form of federal financial assistance these standards virtually have become required for all state and local government audits.

Summary

While the preceding discussion of the 1988 revisions of the Yellow Book does not cover all of the subtle changes to GAGAS, it has highlighted most of the major changes from 1981. The 1988 revision represents an attempt to improve audit quality. It should be anticipated that as the audit environment continues to evolve, generally accepted government auditing standards will continue to change to meet the needs of the various levels of government, the general public, and the auditee. Public accountants accepting engagements of government entities or entities receiving federal financial assistance should implement these new standards immediately.

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U.S. General Accounting Office, *Government Auditing Standards: Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, 1988 Revision.*

U.S. General Accounting Office, *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, 1981 Revision.*

AICPA, SAS #55, "Consideration of the Internal Control Structure in a Financial Statement Audit" (April 1988).