



***Internal
Auditing
in
Federal
Agencies***

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UNITED STATES GENERAL ACCOUNTING OFFICE
1974

Fraud, Waste, and

Abuse

Charge 5131

(not 5114)

**INTERNAL AUDITING
IN
FEDERAL AGENCIES**

Basic principles, standards, and concepts

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ACQUISITIONS

**UNITED STATES
GENERAL ACCOUNTING OFFICE
1974**

FOREWORD

The need for effective internal auditing systems in the Federal agencies has been recognized by the Congress in a number of laws, particularly the National Security Amendments of 1949 and the Budget and Accounting Procedures Act of 1950.

Under the Budget and Accounting Procedures Act of 1950, the Comptroller General, in carrying out his audit responsibilities, is required to prescribe principles, procedures, rules, and regulations for carrying out such work, giving

“ * * due regard to generally accepted principles of auditing, including consideration of the effectiveness of * * * internal audit and control, and related administrative practices of the respective agencies.”*

That act further requires the head of each agency to establish and maintain systems of

“ * * internal control designed to provide * * * effective control over and accountability for all funds, property, and other assets for which the agency is responsible, including appropriate internal audit.”*

The General Accounting Office issued statements of basic principles and concepts of internal auditing for Federal agencies in 1957 and 1968 to assist in carrying out the principles enunciated in the act and to provide guidance to the agencies in developing internal audit organizations and procedures.

In 1972, we published a comprehensive statement of standards for audit of governmental organizations, programs, activities and functions. This statement is applicable to internal auditing in governmental organizations--Federal, State, and local--as well as to external and contract auditing conducted by or for governmental entities. A summary of these standards is attached as appendix A.

Because of the general applicability of these standards in the auditing of Government programs and activities, we have integrated them into this revised statement of basic principles, standards, and concepts of internal auditing in Federal agencies.

The Government Activities Subcommittee, House Government Operations Committee, has taken an active interest in internal audit activities and it issued an important and constructive statement on the subject in 1963. A copy of the pertinent excerpts from the Committee's report is attached as appendix B.

The General Accounting Office has issued numerous reports to the Congress appraising the effectiveness of internal auditing in individual Federal agencies. In carrying out our statutory responsibilities, we expect to make additional reports from time to time bearing upon the adequacy of this important function in all Federal agencies.

As contemplated in the Budget and Accounting Procedures Act of 1950, it is essential that significant internal audit findings be made available directly to the head of the agency concerned and that he assure himself of the adequacy of staffing and the scope of internal audit arrangements in his agency. Evaluating the adequacy and effectiveness of these arrangements will continue to be an important part of our work.


Comptroller General
of the United States

August 1974

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INTERNAL AUDITING IN FEDERAL AGENCIES

BASIC PRINCIPLES, STANDARDS, AND CONCEPTS

MANAGEMENT CONTROL

Management control begins with delegated authority and planned operations and continues through performance and reporting on performance. A well-designed system of management control helps to insure efficiency, economy, and achievement of planned results. Such a system includes providing carefully devised and frequently updated standards of comparison in accordance with which activities are designed and carried on, and against which their output, whatever its form or stage of completion, can be measured.

The essence of management control is the action which adjusts operations to conform with prescribed or desired standards or requirements. To take this action, management needs timely and adequate information on performance.

ROLE OF INTERNAL AUDITING

Information needed by management may come from direct observation; from routine and periodic operating, accounting, statistical, and analytical reports; and from functional or staff reviews. Another important source of information is the internal audit organization which conducts independent examinations and makes reports on its findings and appraisals of operations and performance. The internal audit function uniquely supplements routine management checks through its independent approach and methods of review. This function is one of the essential tools of management, complementing all other elements of management control.

Nature of internal auditing

The overall objective of internal auditing is to assist agency management in attaining its goals by furnishing information, analyses, appraisals, and recommendations pertinent to management's duties and objectives.

Internal auditing is a staff and advisory function, not a line-operating function. Thus, the internal auditor should not have authority to make or direct changes in his agency's procedures or operations. His job is to independently and objectively analyze, review, and evaluate existing procedures and activities; to report on conditions found; and, whenever he deems it necessary, to recommend changes or other action for management and operating officials to consider.

An internal auditor should not be given direct operating responsibilities. Rather, he should be expected to concern himself primarily with the performance of others, to retain an independent outlook in all of his work, and to direct particular attention to matters requiring corrective action. His function is to present his views and suggestions constructively in such a manner as to stimulate or encourage action on his suggestions by others.

Benefits of internal auditing

Management has found that services rendered by the internal auditor in the form of constructive recommendations supported by unbiased, relevant information have aided in meeting many of the problems of both large-scale and decentralized operations. The numerous, complex administrative problems of large organizations impose on management the necessity of delegating a large degree of operating authority within the organizational structure. Management must keep informed on what is happening in the organization at its various levels. Internal auditing is an important means by which management can provide itself with such information and related evaluations.

Management also benefits from timely information on problems on which remedial measures can be taken before the functioning of the organization is impaired. These problems, once they have been examined and appraised, often lead to opportunities for achieving lower costs, increased efficiency, and faster ways of getting things done.

Internal auditing can be of special benefit to the management of smaller organizations, or of small segments of large organizations, where the customary division of duties among employees is not always economical or practical. The internal auditor can often provide additional internal checks and controls required for effective and efficient management.

By reason of his knowledge of management policies and procedures and his contacts with officials and employees at all

organizational levels, the internal auditor can render a valuable service by promoting better communication within an agency. He can obtain first-hand observations on the usefulness or effectiveness of prescribed policies and procedures and he can bring to top management's attention those needing modification, explanation, and interpretation. This type of service can contribute greatly to good management control.

Federal Management Circular

General Services Administration Federal Management Circular 73-2, dated September 27, 1973, sets forth policies to be followed in the audit of Federal operations and programs by executive departments and establishments. The primary objectives of this circular are to promote and improve audit practices, to achieve more efficient use of manpower, to improve coordination of audit efforts, and to emphasize the need for early audits of new or substantially changed programs.

Congressional interest

The Congress recognized the role and usefulness of internal auditing when it passed the National Security Act Amendments of 1949 and the Budget and Accounting Procedures Act of 1950. The last-named act placed responsibility for the institution of this element of internal control on top agency management by providing (in section 113) that:

*The head of each executive agency shall establish and maintain systems of accounting and internal control designed to provide * * * effective control over and accountability for all funds, property, and other assets for which the agency is responsible, including appropriate internal audit * * *.*

Other more recent laws which require internal audits of agency activities include the Postal Reorganization Act of 1970 and the District of Columbia Self-Government and Governmental Reorganization Act of 1973.

The Government Activities Subcommittee, House Government Operations Committee, has taken a strong and active interest in this function in the Federal Government, urging all agencies to adopt effective internal audit systems.¹

¹House Rept. 456, 88th Cong. 1st sess. (1963). See excerpts from Committee's report in app. B.

SCOPE OF INTERNAL AUDIT WORK

To be of maximum usefulness, the scope of the internal auditor's activity should not be restricted. It should extend to all agency activities and related management controls.

The duties of the internal auditor should be clearly stated by the head of the agency, and information concerning these duties should be disseminated throughout the agency to insure full recognition of the nature of his functions at all levels.

Appraising performance

A necessary function of management is to establish and prescribe policies, plans, and procedures for carrying out programs and activities in pursuit of the objectives of the organization and to establish organizational or management systems for review of operations.

The internal audit function can provide a highly valuable service to management by reviewing, appraising, and reporting on the extent and nature of internal compliance with management's policies, plans, and procedures as well as with applicable legal and external regulatory requirements.

The internal auditor's work should include the review of the operation of the whole system of management controls over operations and resources to ascertain whether they are functioning in accordance with their design and are functioning effectively. In organizing his work, particularly in large agencies, he should consider making comparative examinations of similar functions which are performed in the various organizational components of the agency.

In making such examinations, the internal auditor should be alert to possibilities for improving operations and identifying opportunities for bringing about greater efficiency and economy.

As a result of his familiarity with management plans and policies, intra-agency relationships, and procedures and with the manner in which they are working out, the internal auditor should also report observations as to their adequacy and effectiveness in relation to top management objectives together with such recommendations for improvement he considers appropriate.

Elements of an audit

The full scope of an audit of a governmental program, function, activity, or organization should encompass:

- An examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations.
- A review of efficiency and economy in the use of resources.
- A review to determine whether desired results are effectively achieved.

This scope of audit is explicitly set forth as a general standard for governmental auditing in GAO's statement of audit standards (app. A), but it does not imply that every internal audit should be so extensive. Internal audit work should be tailored to meet the needs of management and other users having a legitimate interest in the audit results.

The needs of management officials for assistance of the kind that internal auditors can provide will vary from agency to agency because of differences in nature of operations, organizational structure, location of activities, qualities and competence of officials and employees, and concepts of management control held by top agency officials. An internal audit program should be structured to meet the needs of top management and also be designed to serve the needs of subordinate management levels.

Examining financial operations

The internal auditor should examine financial transactions, including the receipt and disbursement of public funds; accounts; and financial reports to the extent necessary to determine whether:

- The agency is maintaining effective control over revenues, expenditures, assets, and liabilities.
- The agency is properly accounting for its resources, liabilities, and operations.

--The agency's financial reports contain accurate, reliable, and useful financial data and are fairly presented.

--The agency is complying with the requirements of applicable laws and regulations.

In carrying out this work, the internal auditor should evaluate the adequacy of the agency's prescribed policies and procedures and the internal controls related to its financial operations, including the accounting and financial reporting.

The internal auditor should examine whether all revenues arising from the agency's activities were collected and fully accounted for and whether expenditures were made for approved purposes and were properly authorized. He should evaluate whether the agency's procedures result in prices, rates, or fees that conform to applicable laws and regulations.

Prescribed procedures for expenditures should be similarly reviewed for such conformity.

The work of the internal auditor should include examination and testing of accounting and other records and the related procedures underlying the agency's management information system to establish the reliability of the data used by management for internal purposes and for external reports.

The purpose and usefulness of internal reports should be reviewed by the internal auditor as one means of keeping reports responsive to the real needs of users, of avoiding the production of repetitive reports that no longer serve any useful purpose, and of avoiding the distribution of reports to persons having no use for them. He should also ascertain whether changing activities or circumstances are considered in the internal reporting operations.

The internal auditor should be particularly concerned with assets for which the agency is accountable--whether they are fully accounted for and whether procedures being followed adequately protect them from loss, deterioration, or misuse. In examining these matters, he should be alert to the possibility of fraud and dishonesty and to opportunities and practices which could lead to fraud, dishonesty, or loss.

The existence of separate groups within the organization concerned with fraud or other forms of irregularity should not inhibit the auditor from giving close attention to such matters

in his work. When he does encounter such matters, the internal auditor should bring them without delay to the attention of the management.

Evaluating efficiency and economy

The internal auditor should be concerned at all times with minimizing unnecessary or wasteful practices in the use of the agency's resources. He should be watchful for and report on such possibilities as:

- Procedures, whether officially prescribed or merely followed, which are ineffective or found to be more costly than justified.
- Duplication of effort by employees or between organizational units which, if eliminated, could increase overall efficiency.
- Performance of work which serves little or no useful purpose.
- Inefficient or uneconomical use of equipment.
- Overstaffing in relation to work to be done.
- Faulty buying practices.
- Procurement and accumulation of unneeded or excess quantities of property, materials, or supplies.
- Wasteful use of property.

Where functional staff groups exist in an agency which are regularly concerned with such matters as organizational efficiency and personnel use and the making of related studies, the internal auditor should recognize such work and avoid any duplication of effort. However, he should communicate to such groups any observations he may have which are related to their responsibilities.

The operations of such functional staff groups should be subject to the same degree and type of audit as are other parts of the organization.

When practicable, the internal auditor should suggest ways of remedying the weaknesses that he finds; in some cases, he may recommend remedial studies by technical personnel.

Reviewing program results

A review of the results of programs or activities involves inquiring into the results or benefits achieved and whether the programs or activities are meeting established objectives.

Agency management officials have the basic responsibility for continually evaluating their programs and activities to determine the progress being made in achieving established objectives. The auditor whose scope of operations extends to reviewing program results should be initially concerned with evaluating the agency's system for measuring its progress or accomplishments. Major questions he should consider include:

Program effectiveness--Is the program accomplishing the results intended, as spelled out in the legislative objectives or in the implementing directives of the agency?

Cost effectiveness--Is the program succeeding within the costs anticipated at the time the legislation was enacted?

Adequacy of information system--Does top management have the essential and reliable information necessary to exercise supervision and controls and to ascertain direction or trends?

Cost-benefit relationship--Are program costs reasonably commensurate with the benefits achieved?

Consideration of alternatives--Have alternative programs or procedures been examined or should they be examined for potential in achieving objectives with the greatest economic efficiency?

Need for program--Is there a continuing need for the program? Legislation and regulations may not provide for program termination, and it is not unusual for a Government program to continue long after the need it was created to meet has disappeared.

Appropriateness of program--Is the program, as it was designed and implemented, geared to the needs of the particular target group that was used to justify the establishment of the program?

Clarity and consistency of objectives--Are program objectives sufficiently clear to permit agency management to effectively accomplish the desired program results? Are the objectives of the component parts of the program consistent with overall program objectives?

Other factors affecting scope of work

In all of his work, the internal auditor should strive to determine the underlying causes of the errors or adverse conditions he encounters and to formulate recommendations for preventing similar occurrences in the future.

The internal auditor should not be assigned the responsibility for developing and installing methods, systems, or procedures. He should, however, call attention to problem areas and possible improvements and he should be consulted on proposed corrective actions.

The internal auditor should be kept informed of proposed major changes in methods, systems, and procedures, particularly those involving computer applications, so that he can contribute suggestions on them before they are put into effect. Consultation between the systems/computer technicians and the internal auditor, during the systems development phase, helps to insure that adequate controls are established and adequate audit trails are provided in the system so as to avoid costly changes after a new system has been installed.

PERSONNEL QUALIFICATIONS

The staff assigned to perform an audit must collectively possess adequate professional proficiency to perform the tasks required.

Carrying out the type of internal audit described above requires an adequate staff of competent, experienced personnel. The degree to which internal auditing can aid management is proportional to the capabilities of the audit staff and the freedom with which it operates. A program of continuous training and development is essential.

Broad responsibilities and a wide range of services require that the internal auditor be well informed on such matters as his agency's purposes, objectives, programs, policies, operations, activities, and related basic legislation; its budget, fiscal, and accounting procedures and those of the Federal Government generally; legal and regulatory requirements; accounting and auditing principles and procedures; and management practices common to all organizations.

Within the scope of his assigned responsibility, the internal auditor should be capable of making audits at the various

operating levels within the organization. He should be able to recognize problem areas and contribute workable suggestions for improvement. The internal audit manager must see that all audits are conducted by personnel who collectively have the skills necessary for the type of audit that is to be performed.

The qualifications of the staff assigned to the audit should be commensurate with the scope and complexities of its audit assignments. Audits vary in purpose and scope. Some require an opinion on financial statements and an evaluation of compliance with specific laws and other requirements; others require reviews of efficiency and economy; still others emphasize a review of effectiveness in achieving program results; and some require all three elements. Performing all three elements will usually require a wide variety of skills.

Because there are variations in program objectives and organizational forms, as well as differences in laws, rules, and regulations applicable to such programs, the qualifications mentioned herein should apply to the skills of the audit organization as a whole and not necessarily to individual auditors. For example, if an audit organization includes staff members or consultants with acceptable skills in accounting, statistics, law, engineering, actuarial science, and other fields, each individual member of the organization need not himself possess all of these skills.

The internal audit staff must be knowledgeable in auditing theory and procedure, statistical techniques--including sampling--computer operations and applications, management information systems, economics, operations research, governmental organization and operation, and other facets of modern management practices. While an audit staff may consist mostly of individuals with training and experience in accounting and auditing, it should also include or acquire through the medium of contract consultants expertise in mathematics, computer operations, engineering, and other appropriate specialities when warranted by the nature of an agency's programs and activities.

The nature of his work requires the internal auditor to deal successfully with all classes of employees and to be able to communicate with them and others both orally and in writing. He must be tactful and always maintain a good appearance and a professional bearing.

During their examinations, internal auditors have opportunities for becoming acquainted with agency problems and

personnel. The investment of talent and time in internal auditing can also make a material contribution to the development of potential management personnel.

LOCATION IN THE ORGANIZATION

Responsibility of management officials

Internal auditing does not in any way relieve other persons of the responsibilities assigned to them. An internal auditor should not replace established lines of operating authority, and his operations do not eliminate the need for continuing organizational and functional supervision.

Operating officials should be vested with full responsibility for compliance with prescribed policies and procedures, for protection and use of the resources of the agency, and for action in the correction of deficiencies or unsatisfactory conditions coming to their attention, including those reported by the internal auditor.

Independence and reporting level

The position of the internal auditor in the organization should be such that he is independent of the officials who are directly responsible for the operations he reviews. To provide an adequate degree of independence, *the internal auditor should be responsible to the highest practical organizational level, preferably to the agency head or to a principal official reporting directly to the agency head.*

Such positioning is in accordance with the general standard for governmental auditing which places upon the auditor and the audit organization the responsibility for maintaining sufficient independence so that their opinions, conclusions, judgments, and recommendations will be impartial.

Internal auditing cannot be fully effective unless the official to whom the internal auditor reports is a strong supporter of the function, has direct access to the agency head, and has made arrangements to supply all significant audit findings directly to the agency head.

Where the internal auditor does not report to the head of the agency, the function should be placed under the direction of a principal official who does report directly to the agency head so as to insure recognition of its stature and importance in the control system. Also, where the internal auditor does not report to the head of the agency:

- The agency head should satisfy himself that the official to whom the internal auditor reports not only permits but also encourages the internal auditor to exercise latitude in setting the scope of work and in reporting on the results of his audits. The internal auditor should be sufficiently independent to be able to make impartial appraisals of the operation of agency programs and activities, including those under the official to whom the internal auditor reports.
- The head of the agency should concern himself with the scope and effectiveness of the internal audit function and its staffing and with the adequacy of attention paid to audit findings and recommendations.
- The internal auditor, when he deems it necessary to the fulfillment of his responsibilities, should have direct access to the head of the agency.

Centralization

The establishment of a single internal audit organization reporting to the agency head or to a principal official reporting directly to the agency head:

- Provides the advantages of greater independence.
- Fosters a broad viewpoint on the interrelationship of organizations and functions within an agency.
- Places the internal auditor in a better position to make systematic and independent evaluations of and reports on all agency programs, activities, and operations.

A single audit organization also facilitates the attraction and retention of better managerial and staff capability, more effective staff use, and increased coordination of audit effort and interrelated findings. In addition, under unified direction and supervision, a single audit organization permits the devotion of a greater portion of total staff time to specific audit assignments and provides greater opportunities for tailoring staff assignments to the talents and experience of staff members.

Audit staffs in subordinate organizations

A separate internal audit staff should not be attached to a component bureau or similar organization unless management

needs and the size and nature of the bureau's activities are such as to justify an internal audit staff of sufficient size to attract and retain qualified personnel and to make possible the productive and flexible use of staff resources. Decisions on the establishment of such staffs should be made by or be subject to approval by the agency head.

Where an organizational component of an agency maintains its own internal audit staff, the central internal audit activity of the agency should be accountable for furnishing general policy direction and coordinating the efforts of such staff.

The audit coverage by a subordinate audit staff should be included in the scope of the internal audit activity provided for top management. The work of such an organization should be used to the extent practicable in carrying out internal audit work of the top audit group and the effectiveness of the audit work at the lower level should be evaluated as are other control functions.

An internal audit group at the bureau level should be accountable to an official occupying a sufficiently high position to insure its access to any activity of the organization and adequate consideration of and action on its findings and recommendations.

MANAGEMENT OF THE INTERNAL AUDIT FUNCTION

Due professional care

Due professional care must be used in conducting internal audits and in preparing related reports.

This standard of performance requires the auditor to exercise good judgment in devising audit tests and procedures and to do a good job in applying them and in preparing reports. He must effectively supervise his assistants to the extent appropriate in relation to their abilities (see below), maintain effective working relationships with officials of the activity audited, and arrange to follow up on his findings and recommendations.

This standard of performance requires the auditor to be alert for indications of fraud, improper or illegal expenditures or operations, inefficiency, waste, or ineffectiveness. It does not mean, however, that he must make a detailed audit of all

transactions or operations to insure that no material impropriety exists.

It is management's responsibility to institute effective procedures and controls to prevent irregularities and improprieties and to encourage efficient and effective operations under adopted policies and procedures. The auditor's job should be to test these procedures and controls rather than to function as a substitute for them.

Audit manual

A manual should be developed outlining the objectives of internal auditing in the agency, the policies to be followed, the general scope of work to be performed, standards of performance, and reporting requirements.

Planning

Adequate planning of audit work, a basic examination and evaluation standard for governmental auditing, is essential to identify the areas to be covered by the audit staff and to permit systematic scheduling of work and the best use of manpower. However, audit plans should be sufficiently flexible to permit special examinations as new needs or changing circumstances require, thus making possible the best service to management.

Where the audit work includes reviews of the efficiency and economy of operations or achievement of desired results, adequate planning is especially important because the procedures employed in such audits are more varied and complex and, thus, more care is needed to select the appropriate procedures for the case at hand.

Adequate planning should include planning for:

- Coordination with other audit groups, as appropriate.
- Personnel to be used on the assignment.
- Work to be performed.
- The format and general content of the report to be issued.

A written audit program should be prepared for each audit to effectively communicate audit objectives to all staff members, to facilitate control of the audit work during the review phase, and to provide a permanent record of the audit plans. The programs should include any available underlying criteria of performance, including reference to pertinent laws and regulations, to be used for evaluation purposes. When the established criteria for performance are vague, the auditor should attempt to obtain authoritative interpretation of the criteria. If the auditor is required to select measurement criteria, he should strive to reach agreement on the appropriateness of these measures with the interested parties.

Audit programs should include information on :

- Objectives and scope of the audit.
- Background information needed for an understanding of the audit objectives and the operations of the program or activity to be audited.
- Definitions of unusual terms.
- Audit procedures.
- Reporting procedures.

Supervision

Another basic examination and evaluation standard for governmental auditing pertains to supervision of audit assistants. This standard requires that such assistants be properly supervised.

This standard places upon the audit organization the responsibility for insuring that less skilled staff members receive appropriate guidance in the performance of their work. Since training, experience, and other qualifications vary among auditors, specific work assignments must be commensurate with abilities.

The standard also requires that the work of other auditors or professional consultants engaged as a part of an internal audit assignment be subject to the supervisory review of the internal audit staff management.

Supervisory review should be directed to both the substance and the method of auditing. The review should insure that (1) conformance with audit standards is obtained, (2) the audit programs are followed, unless deviations are justified and authorized, (3) the working papers adequately support findings and conclusions, (4) the working papers provide adequate data for preparing a meaningful report, and (5) the auditor will accomplish the audit objectives. Documentation of supervisory reviews should be prepared and retained.

To keep pace with changing conditions, top management should, from time to time, reappraise the agency's internal audit and other internal review activities, especially their coverage and their relationship to changes in the agency's policies and programs. Such appraisals should consider the need to modify the policies and procedures of these activities as necessary to keep them responsive to the current interest of management and other interested parties, and insure continued functioning with minimum interference with operating activities, without duplication of effort, and at reasonable cost.

Evidence and working papers

Obtaining sufficient, competent, and relevant evidence to afford a reasonable basis for the auditor's opinions, judgments, conclusions, and recommendations is another basic examination and evaluation standard for governmental auditing.

Working papers prepared during an audit phase should contain evidence to clearly support the auditors' conclusions and any recommendations made or other observations reported. The evidence gathered and used as supportive material should, in all cases, meet high standards of competence, reliability, and objectivity.

The working papers should (1) be complete and accurate, (2) be clear and understandable, (3) be legible and neat, and (4) contain only those materials directly pertinent to the audit and the related report.

INTERNAL AUDIT REPORTS

The preparation of audit reports is an important part of the internal audit process since it is primarily through reports that the auditor communicates his observations, findings, conclusions, and recommendations.

Form and distribution

All significant audit findings should be brought to the attention of the agency head and other users of audit information in such written form as to make it easy for them to effectively use the information.

Written internal audit reports should be submitted to:

- Management officials who are responsible for the operations or activities reviewed and for making decisions as to actions to be taken on reported findings and recommendations.
- The official to whom the internal auditor is functionally responsible.
- Other officials in the agency who may benefit from the information in the reports.

Top management's role is essential here. By its inattention or inaction, much of the constructive benefit of the internal auditor's work can be lost. On the other hand, its interest in and use of his findings and recommendations can contribute much to the recognition of the importance of his work at all management levels.

The need to prepare written audit reports is not intended to limit or prevent discussions of findings, judgments, conclusions, and recommendations with persons who have responsibilities involving the area being audited. On the contrary, such discussions should be encouraged in order to provide management officials with useful and timely information. However, regardless of whether such discussions are held, a written report should be prepared. On those occasions where corrective action is taken or promised, a less formal type of report, such as a letter to summarize the findings and recommendations and related action or commitment, may suffice.

There are a number of reasons why reports should be prepared in written form:

- So that the results can be widely communicated to responsible officials at all levels of management.
- To make the auditor's findings and recommendations less susceptible to misunderstanding.

--To make the auditor's findings available for public inspection, when appropriate.¹

--To facilitate subsequent followup work to determine whether appropriate measures have been taken in response to the auditor's findings and recommendations.

Timeliness

The value of an audit report is directly related to its timeliness concerning any action required to be taken. Therefore, audit reports should be issued as promptly as possible to make information available for timely use by management and by other interested parties.

The auditor should consider interim communication of significant matters to appropriate officials during his audit work. Such communication is not a substitute for a final written report, but it does alert officials to matters needing correction at an earlier date and permits these officials to institute corrective measures earlier than is possible if the auditor's findings and recommendations are withheld until his final report is completed.

Content

To be effective, audit reports must be carefully prepared and:

--Be as concise as possible but, at the same time, clear and complete enough to be understood by the users.

--Present factual matter accurately, completely, and fairly.

--Present findings and conclusions objectively and in language as clear and simple as the subject matter permits.

--Include only factual information, findings, and conclusions that are adequately supported by enough

¹There are a number of situations where law or regulations prevent issuance of internal reports. Generally, internal auditors should be guided by the practices adopted by their agency for compliance with the Freedom of Information Act.

evidence in the auditor's working papers, to demonstrate or prove, when called upon, the bases for the matters reported and their correctness and reasonableness. Detailed supporting information should be included in the report to the extent necessary to make a convincing presentation.

- Include, when possible, the auditor's recommendations for actions to effect improvements in problem areas noted in his audit and to otherwise make improvements in operations. Information on underlying causes of problems reported should be included to assist in implementing or devising corrective actions.
- Place primary emphasis on improvement rather than on criticism of the past; critical comments should be presented in balanced perspective of any unusual difficulties or circumstances faced by the operating officials concerned.
- Identify and explain issues and questions needing further study and consideration by the auditor or others.
- Include recognition of noteworthy accomplishments, particularly when management improvements in one program or activity may be applicable elsewhere.
- Include recognition of the views of responsible officials of the organization, program, function, or activity audited on the auditor's findings, conclusions, and recommendations. Except where the possibility of fraud or other compelling reason may require different treatment, the auditor's tentative findings and conclusions should be reviewed with such officials. When possible, without undue delay, their views should be obtained in writing and objectively considered and presented in preparing the final report.
- Clearly explain the scope and objectives of the audit.
- State whether any significant pertinent information has been omitted because it is deemed privileged or confidential. The nature of such information should be described, and the law or other basis under which it is withheld should be stated.

Financial reports.

If his audit report contains financial statements or other financial presentations concerning the program or activity audited, the auditor should explain the nature and extent of his audit of such information together with comments on any significant financial issues affecting the reports and compliance with legal or other regulatory requirements.

Each audit report containing financial statements should:

1. Contain an expression of the auditor's opinion as to whether the information in the financial reports is presented fairly in accordance with generally accepted accounting principles (or with other specified accounting principles applicable to the organization, program, function, or activity audited), applied on a basis consistent with that of the preceding reporting period. If the auditor cannot express an opinion, the reasons therefor should be stated in the audit report.
2. Contain appropriate supplementary explanatory information about the contents of the financial reports as may be necessary for full and informative disclosure about the financial operations of the organization, program, function, or activity audited. Violations of legal or other regulatory requirements, including instances of noncompliance, and material changes in accounting policies and procedures, along with their effect on the financial reports, shall be explained in the audit report.

FOLLOWUP

Primary responsibility for action and followup on audit recommendations rests with management. A good control system will include procedures under which management officials will evaluate the effectiveness of actions taken on audit recommendations.

A desirable procedure is to have regular status reports prepared for the information of management officials and the internal auditors, as to actions taken on audit recommendations. Also, provision should be made for regular inquiry into whether proposed corrective actions have, in fact, been taken and their effectiveness. The responsibility for such followup should be that of management officials, but the internal auditors should participate.

Where operating officials disagree with the internal auditor's recommendations, mechanism should be established to reconcile the differences or to call for a decision at a higher management level.

Thus, reporting a finding, observation, or recommendation should not end an internal auditor's concern with the matter. From time to time he should ascertain whether his recommendations have received serious management consideration and whether satisfactory corrective action has been taken.

Internal auditors should also concern themselves with the audit findings of the General Accounting Office and other audit agencies or groups which contain recommendations as to actions to be taken by the agency. They should incorporate, in their followup procedures, inquiry into the nature and effectiveness of those actions.

RELATIONSHIP OF INTERNAL AUDITING TO OTHER AUDITS PERFORMED BY AGENCIES

Auditing of the performance and records of third parties, such as contractors, grantees, or borrowers, is an essential aid to the administration of contracts and of grant and loan programs. The degree of interrelationship between such auditing and internal auditing will vary depending upon the nature, size, and scope of agency programs.

Contract auditing by an agency serves the purpose of determining whether the contractor is complying with contract requirements for the goods or services being supplied to the agency. In the award and administration of negotiated contracts, it is usually necessary to make examinations of requests for cost reimbursement; of the currency, completeness, and accuracy of cost and pricing data used in pricing negotiations; and of activities generating costs to the extent an agency's interests are affected. This type of auditing enables the agency to appraise a contractor's financial responsibility to the Government and to provide information necessary to contract negotiation and administration. It is an essential part of an agency's system of control for achieving its purposes efficiently and economically.

Similarly, the records and performance of grantees or borrowers are subject to audit by the responsible agency as a means of ascertaining whether there has been compliance with

the terms and objectives of the agreements under which Federal funds are granted or loaned. Such auditing, like contract auditing, is an integral part of an agency's system of control in achieving its purposes effectively and efficiently.

The location in the organization of the audit staff responsible for auditing third-party records and performance should be such as to insure that the function effectively serves the program operating officials directly concerned as well as top management and that available audit staff resources are effectively used.

A separate organization of such auditors will be appropriate in many cases because of the size of the organization required to carry out the function; the high degree of specialized knowledge required; or the special need for a close association between program management personnel and the audit staff. In other cases, a single integrated organization of all agency auditors may be desirable.

Regardless of the form or organization adopted, provision should be made for independent internal review of the external audit work to ascertain whether it is being carried out properly and efficiently.

RELATIONSHIP OF INTERNAL AUDITING TO GENERAL ACCOUNTING OFFICE AUDIT RESPONSIBILITIES

The adequacy of the system of internal control, including internal audit, of each Federal agency is of importance to the General Accounting Office in carrying out its statutory audit responsibilities. The Budget and Accounting Procedures Act of 1950 states the duty of the General Accounting Office to consider agency internal auditing as follows:

Sec. 117. (a) Except as otherwise specifically provided by law, the financial transactions of each executive, legislative, and judicial agency, including but not limited to the accounts of accountable officers, shall be audited by the General Accounting Office in accordance with such principles and procedures and under such rules and regulations as may be prescribed by the Comptroller General of the United States. In the determination of auditing procedures to be followed and the extent of examination of vouchers and other documents, the

Comptroller General shall give due regard to generally accepted principles of auditing, including consideration of the effectiveness of accounting organizations and systems, internal audit and control, and related administrative practices of the respective agencies.

Although there are numerous areas of common interest between the General Accounting Office and an agency's internal auditors, certain basic objectives and responsibilities differ. Internal auditing is an integral part of an agency's system of management control. In its audits, the General Accounting Office is concerned with the entire control mechanism within an agency, including the various arrangements made by the management for internal audits and other forms of inspection, appraisal, and evaluation. If warranted by its evaluations, the General Accounting Office will rely on such work and make full use of it in conducting its examinations.

The General Accounting Office is interested in the degree of agency management concern and interest in the work of the internal auditor and particularly in his reported findings and recommendations. The actions taken by management officials on internal audit recommendations are reviewed by General Accounting Office auditors.

The General Accounting Office uses the same techniques of testing and analyzing, to satisfy itself as to the adequacy of internal audit work, as those used in the review of any other function in a Federal agency. This includes a review of work programs and working papers and their adequacy in relation to what was reported. The review may cover some of the same transactions and procedures as those examined by the internal auditor--a procedure essential in testing the quality of the internal audit work.

General Accounting Office evaluations of internal audit systems also include making inquiries of management and operating officials as to the usefulness of internal auditing to them in their day-to-day operations.

Normally, there is little duplication of the work of the internal auditor. The internal auditor performs his work as part of management's pattern of operation and control. The General Accounting Office review is part of the independent appraisal it makes for the Congress of the manner in which Federal agencies discharge their responsibilities and of the effectiveness of their control systems including internal audit.

It makes every effort to keep abreast of the planned work programs of the agency's internal auditors, to consider them in planning its own work, and to avoid, wherever possible, conflicts in audit schedules.

Free and unrestricted access to working papers, records, and reports prepared in connection with internal audit work and other internal review activities is essential for General Accounting Office auditors to effectively review and evaluate their propriety and adequacy. Ready access to such records is also necessary in order that all significant information pertinent to any matter being reviewed by the General Accounting Office may be considered. Such information is necessary in order that, to the extent possible, General Accounting Office findings and reports will be complete, accurate, and objective and thus of maximum usefulness to the Congress and to agency and other Government officials.

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SUMMARY OF GOVERNMENTAL AUDIT STANDARDS ¹

The audit standards below are intended to be more than the mere codification of current practices tailored to existing audit capabilities. Purposely forward-looking, these standards include some concepts and areas of audit coverage which are still evolving in practice but which are vital to the accountability objectives sought in the audit of governments and of intergovernmental programs. Therefore, the audit standards have been structured so that each of the three elements of audit can be performed separately if this is deemed desirable.

General Standards

1. The full scope of an audit of a governmental program, function, activity, or organization should encompass:
 - a. An examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations.
 - b. A review of efficiency and economy in the use of resources.
 - c. A review to determine whether desired results are effectively achieved.

In determining the scope for a particular audit, responsible officials should give consideration to the needs of the potential users of the results of that audit.

2. The auditors assigned to perform the audit must collectively possess adequate professional proficiency for the tasks required.

¹Excerpts from *Standards for Audit of Governmental Organizations, Programs, Activities & Functions*, Comptroller General of the United States (Washington, D.C., U.S. General Accounting Office, 1972.)

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3. In all matters relating to the audit work, the audit organization and the individual auditors shall maintain an independent attitude.
4. Due professional care is to be used in conducting the audit and in preparing related reports.

Examination and evaluation standards

1. Work is to be adequately planned.
2. Assistants are to be properly supervised.
3. A review is to be made of compliance with legal and regulatory requirements.
4. An evaluation is to be made of the system of internal control to assess the extent it can be relied upon to ensure accurate information, to ensure compliance with laws and regulations, and to provide for efficient and effective operations.
5. Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditor's opinions, judgments, conclusions, and recommendations.

Reporting standards

1. Written audit reports are to be submitted to the appropriate officials of the organizations requiring or arranging for the audits. Copies of the reports should be sent to other officials who may be responsible for taking action on audit findings and recommendations and to others responsible or authorized to receive such reports. Copies should also be made available for public inspection.
2. Reports are to be issued on or before the dates specified by law, regulation, or other arrangement and, in any event, as promptly as possible so as to make the information available for timely use by management and by legislative officials.

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3. Each report shall:

- a. Be as concise as possible but, at the same time, clear and complete enough to be understood by the users.
- b. Present factual matter accurately, completely and fairly.
- c. Present findings and conclusions objectively and in language as clear and simple as the subject matter permits.
- d. Include only factual information, findings, and conclusions that are adequately supported by enough evidence in the auditor's working papers to demonstrate or prove, when called upon, the bases for the matters reported and their correctness and reasonableness. Detailed supporting information should be included in the report to the extent necessary to make a convincing presentation.
- e. Include, when possible, the auditor's recommendations for actions to effect improvements in problem areas noted in his audit and to otherwise make improvements in operations. Information on underlying causes of problems reported should be included to assist in implementing or devising corrective actions.
- f. Place primary emphasis on improvement rather than on criticism of the past; critical comments should be presented in balanced perspective, recognizing any unusual difficulties or circumstances faced by the operating officials concerned.
- g. Identify and explain issues and questions needing further study and consideration by the auditor or others.
- h. Include recognition of noteworthy accomplishments, particularly when management improvements in one program or activity may be applicable elsewhere.

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- i. Include recognition of the views of responsible officials of the organization, program, function, or activity audited on the auditor's findings, conclusions, and recommendations. Except where the possibility of fraud or other compelling reason may require different treatment, the auditor's tentative findings and conclusions should be reviewed with such officials. When possible, without undue delay, their views should be obtained in writing and objectively considered and presented in preparing the final report.
 - j. Clearly explain the scope and objectives of the audit.
 - k. State whether any significant pertinent information has been omitted because it is deemed privileged or confidential. The nature of such information should be described, and the law or other basis under which it is withheld should be stated.
4. Each audit report containing financial reports shall:
- a. Contain an expression of the auditor's opinion as to whether the information in the financial reports is presented fairly in accordance with generally accepted accounting principles (or with other specified accounting principles applicable to the organization, program, function, or activity audited), applied on a basis consistent with that of the preceding reporting period. If the auditor cannot express an opinion, the reasons therefor should be stated in the audit report.
 - b. Contain appropriate supplementary explanatory information about the contents of the financial reports as may be necessary for full and informative disclosure about the financial operations of the organization, program, function, or activity audited. Violations of legal or other regulatory requirements, including

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instances of noncompliance, and material changes in accounting policies and procedures, along with their effect on the financial reports, shall be explained in the audit report.

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Excerpts from Report by the House Committee on
Government Operations on "Survey of Selected
Activities (Part 1 - Efficiency and Economy in the
Department of Commerce)"

House Report No. 456,
88th Congress, 1st Session (1963)

Findings and Conclusions

1. *Internal Audit*

Every organization must have an effective system of internal management control. The so-called internal auditing system, as recommended by the Comptroller General in August 1957, constitutes an effective means for the average Federal agency to obtain this essential management function. Unfortunately, this internal audit system has not been adopted on a Government-wide basis. In too many instances, internal audit functions are compromised by inadequate staffs, improper organizational requirements or limits in scope of service. All Federal agencies should review internal management control systems and place them in compliance with the Comptroller General's 1957 recommendations and with the criteria established in this report.

* * * * *

Need for Effective Internal Audit Systems

In the larger Federal agencies, the most promising means of obtaining management control has been the establishment of effective internal audit systems. The Comptroller General in 1957 issued a statement of basic principles and concepts for departments and agencies to follow in the establishment of such systems. For years the Comptroller General and those on his staff working on a day-by-day basis with executive officials have continuously stressed the need for effective internal management controls. The head of a large executive department or agency must have his own "eyes and ears" within the organization, responsible solely to him, independent of operations and with unlimited jurisdiction to review any and all functions wherein waste or inefficiency might exist. * * * However, especially in the larger departments or agencies employing thousands of individuals, involving scores of

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programs, and having offices located throughout the United States and possibly abroad, if the agency head wants to maintain policy control and achieve economy and efficiency, he has no choice but to institute an effective management control system.

Today, there are internal audit groups sprinkled throughout the agencies and departments of Government. The term is well recognized. Unfortunately, recognition of the need for effective internal audits has not always been translated into the establishment of such systems. While many exist, there is considerable room for general improvement.

The committee has established certain fundamentals relating to internal audit operations patterned after the 1957 recommendations of the Comptroller General, with certain refinements reflecting deficiencies in operations uncovered during the hearing:

1. There must be a central internal audit system in every large department or agency organized independent of department or agency operations.
2. The personnel assigned to this management function must have the highest qualifications and the complete confidence of the department or agency head. An accounting background and auditing experience is preferred.
3. All reports and recommendations of the internal audit staff must be submitted in full directly to the agency or department head.
4. The scope of review of the internal audit staff must be unlimited.
5. Personnel assigned to the internal audit function must be protected from recriminations and arbitrary personnel action resulting from the adverse effect their reports might have upon other department or agency employees.
6. The reports and recommendations of the internal audit staff must remain available to the Comptroller General and appropriate congressional committees.

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