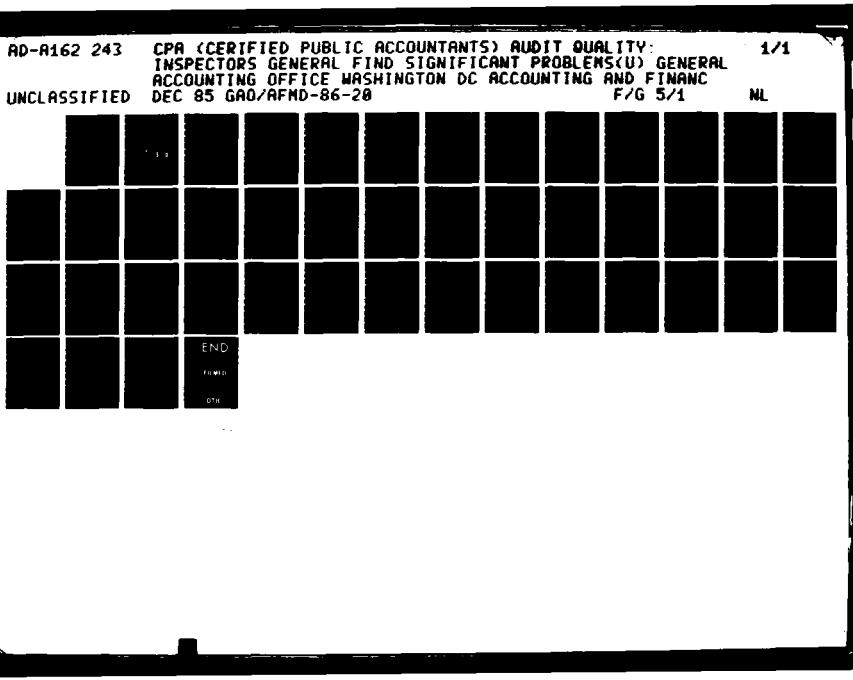
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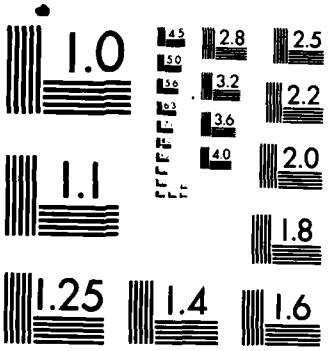

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United States General Accounting Office

GAO

Report to the Chairman, Legislation and National Security Subcommittee, House Committee on Government Operations

December 1985

CPA AUDIT QUALITY

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division
B-219869

December 5, 1985

The Honorable Jack Brooks
Chairman, Legislation and National
Security Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

In response to your request of July 27, 1984, this report describes the results of the first phase of our review of the quality of audits performed by nonfederal auditors—mostly certified public accountants (CPAs). The report sets forth the details of my testimony before you on November 13, 1985, in which I reported on the problems federal inspectors general (IGs) have identified during their reviews of audits. (See appendixes I and II.) I also reported on the systems these IGs employ for monitoring audit quality. To complete our response to your request, we are evaluating a large sample of CPAs' audit work to determine its compliance with professional standards. In this second phase of our work, we hope to independently determine the extent of quality problems on audits of federal funds and identify the causes of these problems.

Our evaluation of the IGs' audit quality review systems encompassed a review of the systems at 46 regional offices of seven agencies' inspectors general. In fiscal year 1984, these seven agencies administered programs that accounted for 95 percent of all domestic federal assistance. We also reviewed a statistical sample of 328 audit reports prepared mostly by CPAs so we could determine what deviations from professional standards the inspectors general identified. In addition to examining the results of the IGs' reviews of audit reports, we evaluated a sample of 223 audits in which the regional IGs extended their review to the supporting working papers to identify problems with general, fieldwork, and reporting standards.

Our review of the IGs' quality control systems show that they identify significant numbers of problem reports and audits. Specifically, we found that:

- IGs identified reporting problems needing correction in one out of four audit reports reviewed. Generally, these problems related to professional standards on reporting.

- In our sample cases, IGs identified and did not accept about one in five audits in which the required audit work was not performed, or the audit documentation was inadequate or unclear, after reviewing the auditors' working papers supporting the audit.

Although we found that the IGs worked with the CPAs to correct problems on individual audits, additional efforts are needed to make use of the data in these individual case files. In this regard, we also noted that:

- IGs have uneven policies and practices for reviewing the work of CPA firms.
- IGs rarely take action against CPAs when they identify unacceptable audit work.
- IGs do not systematically compile, analyze, and use the results of their quality control reviews to correct recurring audit quality problems.

This report contains recommendations to the statutory inspectors general for improving the audit quality review process. The recommendations include calling for the statutory IGs to (1) revise policies for taking actions against CPAs on unacceptable audits, (2) work with the AICPA and state boards of accountancy to expedite referrals to these bodies, and (3) compile, analyze, and use the results of desk reviews and quality control reviews to identify and correct the underlying causes of audit quality problems. If our recommendations are followed, we believe the federal government will be able to place greater reliance on CPA audits of governmental entities to ensure that federal funds are spent for authorized purposes.

We conducted our work between October 1984 and November 1985 in accordance with generally accepted government auditing standards. At your request, we did not obtain comments from the inspectors general on our conclusions and recommendations; however, we verified the data

obtained at each regional inspector general office. We plan to release this report today and forward copies to the inspectors general so that they may take action to respond to our recommendations.

Sincerely yours,

Frederick D. Wolf
Director

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Abbreviations

AICPA	American Institute of Certified Public Accountants
CPA	certified public accountant
DOL	Department of Labor
DOT	Department of Transporation
EPA	Environmental Protection Agency
GAGAS	generally accepted government auditing standards
GAO	General Accounting Office
USDA	Department of Agriculture
HHS	Department of Health and Human Services
HUD	Department of Housing and Urban Development
IG	inspector general
OMB	Office of Management and Budget
PCIE	President's Council on Integrity and Efficiency
RIG	regional inspector general office

CPA Audits of Federally-Assisted Programs Must Be Improved

Introduction and Background

The federal government administers domestic assistance programs through state and local governments with funds exceeding $100 billion per year. The Congress, as well as federal, state,and local officials and private citizens, has a common interest in assuring accountability over the funds in those government programs. They want and need to know if federal funds are being used properly and if programs are conducted consistent with applicable laws and regulations.

Grantees or federal agencies contract directly with nonfederal auditors—mostly certified public accountants (CPAs)—to audit much of these funds. These auditors assure program managers that they have reliable reports on (1) the financial activities, (2) compliance with the requirements of laws and regulations, and, in many cases, (3) the extent of internal controls over federal expenditures. This report addresses the audit quality reviews performed by inspectors general (IGs) in many of these audits of federal grants to state and local governments, and single audits of entities receiving federal funds prior to passage of the Single Audit Act of 1984.

This review was performed at the request of Jack Brooks, Chairman, Legislation and National Security Subcommittee, House Committee on Government Operations. The subcommittee has a long-standing interest and commitment to audit quality. The subcommittee has been instrumental in passage of legislation in this area, including the Single Audit Act of 1984 and the Inspector General Act of 1978. GAO shares the subcommittee's interest, and has supported these legislative initiatives. We believe, and testified before the subcommittee, that the Single Audit Act will go a long way towards improving the audits of federal funds and in promoting controls over and management of those funds.

We believe it is essential that, as the Single Audit Act is implemented, measures be taken to avoid problems with audit quality that have surfaced in the prior grant-by-grant and single audits. Hence, this study was undertaken to identify those problems and to recommend ways to avoid them as the audit community moves towards implementing the Single Audit Act.

While GAO has raised the subject of audit quality in many reports over the past two decades[1], for the most part, those reports focused on problems of selected audits in several agencies. This request—that GAO study

[1] Many Proprietary Schools Do Not Comply With the Department of Education's Pell Grant Program Requirements, GAO/HRD-84-17, Aug. 20, 1984.

the quality of audits of federal grants to state and local governments and nonprofit organizations—has resulted in our most extensive review of audit quality issues to date.

Because of the magnitude of the subcommittee's request, GAO established an Audit Quality Task Force and divided its review work into two phases. The first phase was aimed at evaluating both the quality of the offices' of inspectors general audit quality review systems as well as reporting on the results of the IGs' reviews of audits performed by nonfederal auditors. The second phase of our review was aimed at determining the extent to which certified public accountants comply with professional auditing standards on their audits of recipients of federal assistance, as well as determining the overall quality of their audits.

The basic question we want to address in these two phases of our review is whether those audits are conducted in a manner that provides reasonable assurance that any problems are identified and, if identified, are properly reported. Our first phase will respond to this question by looking at what the IGs do to answer this question and reporting on what their answers are. In our second phase, we will review and assess a sample of those audits. We will also look at the results of other studies that have been performed in this area.

This report focuses on the first phase of our work—the role that inspectors general play in the audit quality review process and the results of their work. It will describe the extent to which the IGs have identified audit quality problems during their reviews of audits, and discuss some of the common problems identified. It will also describe the systems the inspectors general have in place to review audit work and recommend ways they can improve their audit quality review systems to be more effective.

Before discussing our review results, it is important to understand two things. First, how we and others in the accounting profession define a quality audit, and second, the role the inspectors general play in assuring audit quality.

Quality Testing of Audits of Grantee's Records--How It Is Done by Selected Federal Agencies and What Improvements are Needed, FGMSD-79-38, July 19, 1979.

Using Independent Public Accountants to Audit Public Housing Agencies--An Assessment, CED-76-133, Aug. 25, 1976.

Need for More Effective Audit Activities, B-130515, Apr. 14, 1973.

What Is Audit Quality?

The term "audit quality" has many connotations. In the context of our work, we define "audit quality" as compliance with professional standards set out for the particular type of audit being conducted. To help ensure consistency in the scope and quality of audit work and preparation of professional and meaningful reports, both we and the American Institute of Certified Public Accountants (AICPA) have issued standards that auditors must follow.

Over the years, the AICPA has set auditing standards through various committees, and, since October 1978, through the Auditing Standards Board. The Auditing Standards Board interprets generally accepted auditing standards through "Statements on Auditing Standards." These standards apply to audits performed to express opinions on an organization's financial statements. The AICPA also issues Industry Audit Guides and other material to assist auditors in the performance of their work and which further codify auditing standards in certain specific industries, such as state and local governments.

Auditing standards issued by GAO are published in the document Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, [1981 Revision] commonly referred to as "Generally Accepted Government Auditing Standards" or GAGAS. Generally, auditors must follow these auditing standards on audits of recipients of federal funds received by contractors, nonprofit organizations, and other external organizations. These standards are broader in scope than those set by the AICPA and cover economy and efficiency and program results work, as well as financial statement audits. In the area of financial statement audits, these standards have one significant difference from the AICPA's standards. GAGAS requires, in addition to an opinion on financial statements, a statement on internal controls and a statement on compliance with laws and regulations.

In regard to the issues of internal control and compliance work and the difference between so called "commercial" audit standards and any "government" audit standards, it should be noted that the primary distinction is in reporting requirements—not audit requirements. All auditing standards require that important internal controls be evaluated either directly through internal control reviews or indirectly through expanded substantive testing. Likewise, if significant funds are received under a contract, grant, or other similar arrangement which requires compliance with specific contractual or legal terms, then compliance testing is required since noncompliance can result in a significant impact on the entity being audited.

In conducting the audit of an entity or a grantee, under GAGAS, the auditor must conduct a review of compliance in accordance with laws and regulations and at least a preliminary review of the entities' internal accounting controls. The auditor's report must contain a statement on the entity's compliance, including identifying material instances of noncompliance, and a statement on internal accounting controls reviewed. The federal agencies rely on these two sections of the auditor's report to assure that the audited entity is managing the programs in compliance with federal laws and regulations. These requirements were clarified and amplified in the Single Audit Act of 1984, particularly in the areas of compliance, and accounting and administrative controls.

The Inspector General Act of 1978, as amended, requires that the inspectors general take appropriate steps to ensure that any work performed by nonfederal auditors of federal organizations' programs, activities, and functions complies with these standards. As a result, requirements for following GAGAS when performing audits of federal funds have generally been included in audit contracts or engagement letters.

In addition to these applicable professional standards, audits are often subject to the provisions of program audit guides or other guidance provided to the CPA by the federal agencies or the entity under audit at the time a contract is signed. Audit guides typically set out a framework for conducting and reporting on an audit engagement and normally include detailed steps and suggested language auditors should follow. Audit guides for specific programs are normally prepared by the agency inspectors general.

IG's Role in Assuring Audit Quality

The IGs have played an important role in reviewing audit reports for adherence to professional standards. Section 4(b)(3) of the Inspector General Act of 1978 states that inspectors general will "take appropriate steps to assure that any work performed by non-federal auditors complies with the standards established by the Comptroller General...." The act only addresses the IGs' audit quality review function in general terms, and does not specify the steps the inspectors general must take to accomplish this function.

We have identified 15 elements which constitute a typical IG quality review process. They compose the process against which we evaluated the IGs' activities and are discussed in detail later.

Objectives, Scope, and Methodology

The scope of GAO's work consisted of analyzing the results of independent random samples of desk reviews and quality control reviews at seven IGs. It also included an evaluation of these IGs' audit quality review systems to determine the ways they assure that work performed by nonfederal auditors complies with generally accepted government auditing standards. We selected the following seven agencies' IGs for our review:

- The Department of Agriculture (USDA),
- The Department of Education (Education),
- The Department of Health and Human Services (HHS),
- The Department of Housing and Urban Development (HUD),
- The Department of Labor (DOL),
- The Department of Transportation (DOT), and,
- The Environmental Protection Agency (EPA).

These agencies were chosen for our study because they administered programs accounting for 95 percent of all domestic federal assistance in fiscal year 1984.

The IGs decentralized the audit quality review function to their regional offices. Consequently, we conducted the majority of our work at these IGs' offices in seven regions. Because some IGs did not have offices in all seven regions we visited, this report is based on work performed at a total of 46 IG regional offices (RIGs).

Our first objective was to compile and report on the results of the RIGs' desk reviews and quality control reviews of audit reports received during fiscal year 1984. To accomplish this, we determined, through discussions with regional officials and examinations of report logs, the number of desk reviews performed by RIGs at the 46 locations. We then determined the number of quality control reviews performed on these audits, based on input logs and other records. Based on our work, we estimate that the 46 RIGs desk reviewed 9,530 reports in fiscal year 1984 and performed quality control reviews on 885 of these audits. Our estimates are based on a 95 percent confidence level with a sampling error of between 5 and 6 percent.

Reports reviewed for quality by the inspectors general constitute only a portion of all audits performed on federal funds. In fact, approximately 25,000 audits came to our attention that are reviewed at the state level or by federal program officials and that are not in the scope of our

review. The majority of these audits are of HUD housing projects which are reviewed by program offices.

In order to compile the results of the IGs' reviews, we used a standardized data collection instrument to record the IGs' findings. In reviewing each report, we examined correspondence, checklists, and all other documents in the case file. We attempted to relate problems identified by the RIGs to GAGAS, but because the IGs' reviews were often not tied to these standards, it was often necessary for us to determine the applicable standards affected based on our best judgment after reviewing the case files.

Our second objective was to identify the systems the RIGs have to assure that nonfederal auditors comply with generally accepted government auditing standards. To do this, we identified 15 elements in a typical audit quality review system based on our discussions with officials in the IG community and through our examination of the IGs' current policies for assuring audit quality. We collected data with respect to all 15 elements, but concentrated our analysis on ten elements we believed were most critical to an effective system. Our results were based on discussions with RIG officials at the 46 locations we visited, a review of IG policies and procedures at the regional level, and our own testing to verify how well the systems were, in fact, working. The results of this aspect of our work are generally reported for IG regional offices, rather than for agency IGs as a whole.

The Results of Regional Inspector General Audit Quality Reviews

RIGs have audit quality review systems that are primarily designed to detect and correct problems of unacceptable work on individual audits. As a major part of those systems, RIGs perform desk reviews and quality control reviews.

A desk review is a review of an audit report for conformity with professional standards—usually reporting standards—and for identification of items needing clarification. Desk reviews are typically performed for one other important reason, and that is to identify and record audit findings in the report that have to be resolved by the program managers. Desk reviews are limited to a review of the audit report itself, and do not include reviews of the auditor's supporting working papers. Hence, they are not designed to enable the RIGs to directly evaluate the quality of the audit performed.

A quality control review, on the other hand, includes a review of the auditor's working papers to ensure that the audit conforms with all applicable professional standards. Typically, quality control reviews involve substantially more time and effort on the part of IGs than do desk reviews.

The RIGs typically desk reviewed 100 percent of the audits they received. They usually conducted quality control reviews on at least 5 percent of these audits. The decision regarding which audits to subject to quality control review is largely judgmental and is generally based on criteria such as institutional memory of prior RIG experience with the CPA firm, the results of the RIG's desk review of the report, and whether the firm has ever previously contracted to provide audit services for the agency.

The RIGs' audit quality review systems enable the RIGs to identify and have the auditors take corrective action on numerous cases of audit work they would not accept. However, since these results, for the most part, remain in the individual case files, regional or headquarters officials generally do not know the extent or type of problems being identified by the reviews. We therefore compiled the following results from the RIGs' case files. Although we did not verify the accuracy of the RIGs' individual reviews, based on our review of correspondence between the RIGs and the CPA firms, they generally appear to have been adequately performed.

Results of RIG's Desk Reviews of Audit Reports

Our analysis of the audit reports reviewed in our sample indicated that the RIGs had problems with 25 percent of those reports. We estimate that the RIGs had problems with 2,410 of the 9,530 audits they desk reviewed.[2]

The problems identified by the RIGs concerned the way the reports were presented and ranged from leaving off the date of the report to omitting a required statement on compliance with laws and regulations. Generally, the RIGs were successful in having auditors correct their reports.

[2]Estimated with 95 percent confidence that the rate of occurrence of problem audits, taken as a percentage of all audits that IGs desk reviewed, was 25.3 percent with a sampling error of 5.0 percent.

We reviewed a sample of 328 audits and identified 84 where the RIGs found problems[3] related to standards requiring the auditors to:

- identify instances of noncompliance with laws and regulations (42 reports),
- identify internal controls studied and evaluated (19 reports),
- use due professional care in preparing audit reports (65 reports), and
- correctly cite the auditing standards followed (18 reports).

Because a desk review is limited to a review of the report only and not the working papers, it usually does not enable the RIG to identify problems regarding the work itself. The work itself is only evaluated in a quality control review. Our analysis of the results of the RIGs' quality control reviews is discussed later in this statement.

Statement on Compliance With Laws and Regulations

In governmental auditing, compliance with laws and regulations is significant because government organizations, programs, activities, and functions are usually created by law and have more specific rules and regulations than do private organizations. Generally accepted government auditing standards require auditors to include in their reports a statement of positive assurance on those items of compliance with laws and regulations they tested, a statement of negative assurance on those items they did not test, and a description of material instances of noncompliance and instances or indications of fraud, abuse, or illegal acts they found during or in connection with their audit.

Positive assurance consists of a statement by the auditors that the tested items were in compliance with applicable laws and regulations. Negative assurance is a statement that nothing came to the auditor's attention, as a result of specified procedures, that would cause the auditors to believe the untested items were not in compliance with applicable laws and regulations.

Many of the problems RIGs had with auditors' reports related to statements on compliance. For example, RIGs found reports which did not include a statement on compliance. Other reports included a general statement but omitted either the statement of positive assurance or the statement of negative assurance. RIGs also identified numerous instances where auditors failed to report, or inadequately reported findings of

[3]The sum of these reports exceeds 84 because some reports had problems related to more than one standard.

noncompliance with laws and regulations. Without the statement on compliance, the CPA does not attest to having performed the required work in this important area.

Statement on Internal Controls

Generally accepted government auditing standards normally require auditors to study and evaluate internal accounting controls and report thereon, as part of financial and compliance audits. A study and evaluation of internal controls establishes a basis for determining the extent of auditing procedures to be used and is an important step in forming an opinion on the financial statements. The reports should identify the entity's significant accounting controls, the controls evaluated, the controls not evaluated and the reasons therefore, and any material control weaknesses identified.

RIGs had problems with many auditors' reports relating to internal accounting control reporting. For example, RIGs found reports which included no statement on internal accounting controls. Other reports included a statement on controls, but did not identify the entity's significant controls, or having identified the controls, did not identify the controls that were evaluated.

Due Professional Care

Generally accepted government auditing standards require auditors to use due professional care in preparing audit reports. Due professional care requires professional performance of a quality appropriate for the audit assignment undertaken. It also means using good judgment in preparing audit reports.

Many of the problems RIGs had with auditors' reports related to due professional care. For example, RIGs found instances where the auditors' reports contained financial statements with unexplained inaccuracies, such as accounts not in balance, incorrect accounts, incorrect adjusting entries, and improper reporting formats. There were audit reports with missing schedules, missing information, and inadequate descriptions of the scope of audit work performed. Other reports omitted the date of the report,[4] did not contain the auditor's signature, or did not properly cite the agency guidance followed in the conduct of the audit.

[4]Omitting the date from the audit report is not an insignificant item because the auditor is required to disclose events that occur between the date of the financial statements and the date of the report that have a material effect on the financial statements.

Statement on Auditing Standards Followed

Generally accepted government auditing standards require auditors to state in their reports that their examination was made in accordance with such standards. RIGs identified reports that did not cite generally accepted government auditing standards, did not cite any standards, or cited the standards but referenced standards that had been superceded. Without the correct citations, the reader is not clear as to the standards against which the CPA maintains the audit was conducted.

We believe that the results of the RIGs' desk reviews indicate a lack of awareness by CPA's of GAGAS reporting standards and other requirements for governmental audits. Given these results and the importance of performing desk reviews to identify audit findings for resolution, we believe that desk reviews should continue to be an integral part of RIGs' audit quality review systems. Further, as explained in the next section of this report, we believe IGs can better use desk review results to prevent audit quality problems from recurring.

Audit Quality Control Reviews

RIGs normally performed quality control reviews on at least 5 percent of those reports desk reviewed, but the percentage varied widely among agencies. As described earlier, the RIGs did not usually select audits for quality control review on a random basis. They selected audits largely based on their judgment as to which firms were more likely to have problems. Consequently, the results of RIGs' quality control reviews are not necessarily indicative of the frequency of problems in the universe of audits performed by CPAs as a whole. Rather, they are skewed towards a higher level of problem audits. Despite this, we believe that the results of RIGs' quality control reviews indicate that serious problems occur in a substantial number of governmental audits.

To determine the results of the RIGs' quality control reviews of audits, we selected independent random samples of audits that we determined from IG records had been quality control reviewed at the 46 regional IG offices. From an analysis of these samples, we estimate that the seven IGs conducted 885 quality control reviews.[5] We further estimate that the RIGs identified problems with 399, or about 45 percent of these reviews.

[5]Estimated with 95 percent confidence that the rate of occurrence taken as a percentage of all audits the IGs quality control reviewed was 45.1 percent with a sampling error of 5.8 percent.

Furthermore, the RIGs did not accept, as submitted, about 22 percent[6] of the audits. In other words, one out of every five audits the RIGs quality control reviewed was not accepted until the auditor (1) performed more audit work, (2) clarified work performed, or (3) provided more support for the audit work performed. A few were in fact never accepted. Audits that were not accepted by the RIGs most often involved failings related to the standard requiring the auditors to obtain and document sufficient competent evidential matter to support their conclusions and opinions.

Evidence

Generally accepted government auditing standards require auditors to obtain sufficient, competent, evidential matter to support their conclusions and opinions. The nature, timing, and extent of the procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor, based on specific circumstances. However, the procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads, all bear on its competence.

A written record of auditors' evidence must be retained in the form of working papers. As a general rule, working papers should contain the results and scope of auditors' examinations and be clear and understandable so that they do not require detailed, supplementary, oral explanations. While the quantity, type, and content of working papers vary with the circumstances, they normally should include evidence showing that:

- Audit work has been adequately planned and supervised.
- Testing of compliance with laws and regulations has been performed and exceptions have been identified and resolved.
- Internal accounting controls have been studied and evaluated.
- Accounting transactions, balances and financial items, and any related evidential matter have been examined.

Insufficient evidence was the most common problem RIGs found in audits they would not accept. RIGs found audits where there was little or no

[6]Estimated with 95 percent confidence that the rate of occurrence taken as a percentage of all audits the IGs quality control reviewed was 22.4 percent with a sampling error of 4.9 percent.

evidence showing that the auditors properly planned the audit or supervised and reviewed the audit. RIGs found audits where there was little or no evidence showing testing of compliance with laws and regulations. At least two-thirds of the audits with evidence problems involved problems in the compliance area; either the evidence was lacking or, more significantly, no or inadequate testing of compliance was done. RIGs also found audits where there was insufficient evidence documenting the auditors' study and evaluation of internal controls; again, either the evidence was lacking or the work was not performed. In addition, RIGs found audits where there was insufficient evidence of auditors' testing of financial operations or transactions.

The AICPA has also identified problems in audits of federal funds by CPAs. In a study begun in late 1979 with a final report issued in 1984, the AICPA's Ethics Division found problems related to professional standards on nearly half of two hundred reports submitted to it by federal inspectors general. These reports were selected by the RIGs based largely on their preliminary review, and therefore, were part of a judgmental, rather than a statistically valid random sample. The results, however, are similar to what the IGs' quality control reviews continue to disclose.

In this study, the AICPA investigated 106 cases which resulted in the following actions:

- Four were referred to the trial board for disciplinary action.
- Twenty-three were given administrative reprimands of which 21 required CPAs to take continuing professional education credits, and in some of those instances, have their future work reviewed.
- Sixty-four were sent letters of constructive comment for improvement in future audits.
- No action was taken on 15 cases.

Examples of Unaccepted Audits

Described below are illustrations of audits RIGs did not initially accept. The examples include problems related to evidence, as well as other standards.

- In Tennessee, a CPA contracted to perform an audit of a city's housing authority. The Atlanta HUD regional IG rejected the audit report because the RIG determined that there was (1) no evidence in the working papers of supervision of the audit, (2) insufficient support for the findings and conclusions, (3) insufficient evidence that required tests to determine compliance with laws and regulations were made, and (4) insufficient

evidence of the auditor's study and evaluation of internal controls over accounting records and financial reporting procedures, cash receipts and disbursements, investment of excess funds, submission of funds due HUD, and budgetary controls. These problems were noted in a quality control review performed after the auditor did not respond to problems noted by the RIG in his desk review of the audit report.

- An HHS RIG found that a CPA firm contracted to audit a Colorado Head Start grant and one of its staff members hired the Head Start program's bookkeeper to assist in the audit. In addition to noting the lack of independence, the RIG noted that no internal control work was performed and that only part of the required testing for compliance with laws and regulations was completed. The CPA firm's staff member responded that since he personally designed and implemented the system of internal control for the program, there was no need to question or test the internal control system. The CPA completed the additional compliance tests, and the RIG issued the report cautioning program officials to be careful about relying on the report due to the question of independence.
- In New York, on an audit of an educational institution, the Education RIG found that the required compliance and internal control work was not properly documented by the auditor. In his report, the auditor included required statements that he performed all work in accordance with professional standards, even though that was not the case. The auditor did not submit required documentation to satisfy the IG that additional work was performed. The IG subsequently performed additional work and found poor internal controls and material cases of noncompliance with program regulations. The OIG rejected the report and referred the CPA to the New York State Board of Accountancy and the AICPA.
- In Texas, a CPA contracted to perform a single audit of a city. The Fort Worth HUD regional RIG would not accept the audit report because he found (1) no evidence of supervision, (2) insufficient evidence that required tests to determine compliance with laws and regulations were made, (3) insufficient documentation of the auditor's study and evaluation of internal controls to clearly show the relationship between the review of internal accounting controls and substantive testing, and (4) financial information in the report that could not be reconciled. The RIG, in July 1984 and October 1984, asked the CPA to revise his report and perform additional work based on the results of a desk review and quality control review, respectively. The RIG finally accepted and issued the report in May 1985.

Improvements Should Be Made to Assure Better RIG Monitoring of CPA Audits

The prior section described some of the RIGs' audit quality review results and explained the types of problems noted in the RIGs' desk and quality control reviews. With the full implementation of the Single Audit Act of 1984, greater audit coverage will be devoted to federal funds. Further, we believe that the audit quality review function will continue to be crucial in ensuring that auditors understand what professional standards and other guidance they need to follow in the conduct of their audits as well as in the preparation of reliable audit reports.

As mentioned earlier, the inspectors general are required to take appropriate steps to assure that nonfederal auditors comply with GAGAS, but are not required to follow specific procedures to ensure high quality work by these auditors. We studied the RIGs' existing audit quality review systems and identified the key elements of a typical system. (See appendix II.) The typical system that we identified consisted of 15 elements involving the three stages of the quality review process—securing audit services and reports, quality review, and using quality review results.

The elements were developed, in part, from existing agency manuals, the Office of Management and Budget (OMB) Circular A-102 Compliance Supplement, and through discussions with several officials in the IG community, as well as our observations at the 46 RIGs we visited. We evaluated the RIGs' audit quality review systems focusing on 10 of the 15 elements that we determined were most critical to an effective quality review process. We interviewed headquarters and RIG officials to evaluate how they assured audit quality, reviewed agency guidance, and tested their systems to see how well they were working in relation to our 10 elements.

Our work showed that the headquarters IGs decentralized much of the audit quality review function to the RIGs. Although we found that each headquarters IG had provided regions with some written guidance on performing this function, the 46 regions we visited were, for the most part, developing and implementing their audit quality review systems locally. We found that all of the RIGs had some type of audit quality review system to assure the quality of work by nonfederal auditors but the scope of work varied significantly among regions.

Based upon our review, we believe that the RIGs could be more effective in identifying and combating poor audits if they improved their systems in areas related to these 10 elements. Specifically, we believe the IGs could do more to

- provide accurate written guidance to grantees and CPAs to assure compliance with GAGAS (element 3),
- improve desk and quality control review programs, specifically in the scope and format of the checklist guidance the RIGs use to identify quality problems (elements 5, 6, and 7),
- take more frequent actions against CPAs to increase the reliability of audit reports (element 9),
- compile and analyze the results of audit quality reviews at the regional level to identify and act to prevent recurring quality problems (elements 10, 12 and 13), and
- require regional offices to report on problem audits to headquarters so that headquarters can advise the Congress on its efforts to monitor audit quality (elements 14 and 15).

Provide Accurate Written Guidance to Grantees and CPAs

The inspectors general help assure audit quality through their preparation of program audit guides, which are distributed to most CPA firms at the beginning of the audit engagement. The audit guides often include detailed requirements for performing audits and reporting audit results, including specific audit procedures and suggested report language. CPAs rely on audit guides, in addition to applicable professional standards, to plan and carry out their audit work.

We evaluated 11 of the audit guides that are widely used at the 46 RIG offices. We determined whether the selected audit guides (1) specified audit objectives, (2) listed audit procedures for testing compliance, and (3) included the appropriate reporting requirements. In our evaluation of the universe of 9,530 reports desk reviewed by inspectors general at the seven federal agencies, we found that outdated audit guides contributed to some audit reports not satisfying the reporting standards specified in GAGAS.

Some Audit Guides Included Outdated Report Language

We found that 8 of the 11 program audit guides we reviewed at six[7] IGs did not reference the current (1981) version of GAGAS—the year substantial revisions were made to these standards.[8] As a result, the audit

[7]DOT regional officials told us they did not provide CPAs with audit guides for audits of their grant programs.

[8]These standards have been revised in order to
—expand the explanations of some standards in response to questions about them,
—separate the standards for financial and compliance audits from those for economy and efficiency audits and program results audits,
—incorporate standards relating to audits in which automatic data processing systems are used by

guides did not include sample audit report language that accurately referenced GAGAS and that was consistent with reporting standards contained in GAGAS. Since audit guides were relied upon by CPAs in reporting the results of their work, we estimated, from our reviews of audit reports, that 79 percent, or about 7,500 of the estimated 9,530 reports[9] contained inconsistencies with the language of the current GAGAS reporting standards due to the guides being inaccurate or outdated. When audit reports do not contain language consistent with established standards, the nature, extent, and results of the auditors' examinations have not been adequately disclosed to the users, even though the audit may have been conducted in accordance with standards.

We found audit reports that contained improper report language from outdated audit guides. The following three reporting standards were among those most often violated:

- A statement shall be included in the auditors' reports that the examination was made in accordance with generally accepted government auditing standards for financial and compliance audits.

  - [GAO Note: Reports did not properly reference GAGAS—42 percent of the reports.]

- Either the auditors' reports on the entity's financial statements or a separate report shall contain a statement of positive assurance on those items of compliance tested and negative assurance on those items not tested.

  - [GAO Note: Reports did not include statement of positive and/or negative assurance—58 percent of the reports.]

- The auditors shall report on their study and evaluation of internal controls made as part of the financial and compliance audit.

  - [GAO Note: Reports did not identify the significant internal accounting controls, which were reviewed and/or identify material weaknesses found. Others did not include an explanation of why the auditor chose not to study and evaluate internal controls—72 percent of the reports.]

the entity, and
—add a standard to make more specific the auditor's responsibility for detecting fraud and abuse in government programs and operation.

[9]Estimated with 95 percent confidence with a sampling error of 4 percent.

The RIGs did not identify the above inconsistencies as report problems because they told us the CPAs relied on guidance the RIGs had prepared. Some RIG officials told us that they were hesitant to revise and update their audit guides because they believed the guides would become obsolete after implementation of the single audit legislation. However, during our study, we found that some of the RIGs are now requiring CPAs to follow all reporting standards. For example, in one HHS region, audit reports consistently failed to include GAGAS reporting requirements because the audit firms relied on a prescribed reporting format included in the Head Start Program Audit Guide. An HHS official told us that it now requires CPAs who perform audits of this program to follow all reporting standards.

We believe that audit firms share the responsibility for issuing audit reports that were deficient in these areas. The AICPA's Codification of Statements on Auditing Standards states that auditors should make appropriate revisions to prescribed formats which do not incorporate current reporting standards. The 1984 version of the codification states that auditors should be aware of the latest accounting and auditing pronouncements as part of their planning efforts.

Even though a new comprehensive compliance supplement, suggesting audit procedures, will generally be used in conjunction with single audits, program audit guides will continue to be applicable in many situations. Specifically, audit guides will be used whenever additional audit work is undertaken to build on work performed in a single audit, or when entities who are eligible to choose a grant, rather than single audit, do so. We believe that RIGs should revise their program audit guides to include proper references to reporting standards so that reports distributed to program managers are properly written. We believe that this guidance is the best opportunity RIGs have to influence proper reporting, even before the audit gets underway.

Improve Desk and Quality Control Review Program

We believe that effective desk and quality control reviews are essential to the RIGs' audit quality review systems. Desk reviews not only help RIGs identify problems with report language, but they also help the RIGs select potentially problem audit firms on which to perform quality control reviews. Since RIGs have limited resources available for this activity, reviews must be effective so that they can ensure properly written reports and emphasize to the accounting profession the importance of producing high quality work.

We believe, based on our reviews at the 46 RIGs we visited, that the IGs could be more effective in the desk and quality control review function if they (1) required all of their RIGs to perform quality control reviews on an established percentage of the audit reports they receive and (2) used standardized checklists tied to the professional standards.

Establish Goals for Quality Control Reviews

Six of the seven IGs in our study had policies requiring quality control reviews on at least 5 percent of the audit reports they received. The seventh IG did not require a minimum level of effort in its quality control review program. We found that a total of 33 of the 46 RIGs we visited actually performed quality control reviews on at least 5 percent of their reports. The following chart shows the range of effort devoted to this activity.

Table I.1: The Number of RIGS Performing Quality Control Reviews (By Percentage Categories in Fiscal Year 1984)

Agency	Less than 5%	5%	Between 5% and 10%	10%	Over 10%	Total
Education	1	2	3	0	1	**7**
DOL[a]	5	1	0	0	0	**6**
DOT	1	0	3	0	3	**7**
EPA[a]	0	0	1	0	4	**5**
HHS	3	0	3	1	0	**7**
HUD	0	0	7	0	0	**7**
USDA	3	0	0	0	4	**7**
Total	**13**	**3**	**17**	**1**	**12**	**46**

[a]These IGs did not have offices in all seven regions we visited.

Several RIG officials told us that the number of quality control reviews they performed was limited by the amount of resources available. Others stated that they considered quality review to be a low priority in their region. We believe that the benefits realized—both in identifying potentially problem firms and in ensuring an overall high level of quality—warrant resources to quality control an established percent of the reports in every RIG office.

While any percentage is arbitrary, we believe that, if coupled with the analysis and recourse steps discussed below, the percent of audits quality control reviewed can be kept relatively low. This would be especially true, in our opinion, after the first few years of single audits under the 1984 act. Further, we believe target goals should be revised as experience is gained under the act.

Develop More Useful and Consistent Review Checklists

Almost all of the 46 RIGs relied on quality control review checklists to guide their reviewers through examinations of audit reports and working papers to identify problems that would necessitate revisions to the report, additional fieldwork, or additional working paper documentation. A checklist or other similar document is designed to ensure that the RIG reviewer take a consistent approach to his review. When checklists are not used, the effectiveness and consistency of quality reviews depend upon the reviewers' ability to independently identify deficiencies in the audit and audit report and to interpret them as violations of professional standards.

We reviewed an unbiased, judgmental sample of checklists to determine if the same ones were used consistently among all regions of each IG and to see if they related problems found in the quality review to violations of professional standards. Our sample included desk review and quality control checklists for both grant and single audits.

We found that none of the agencies had checklists that were used at all of their regional offices we visited. Many regions developed their own checklists from sections of others or adopted checklists which were developed by professional auditing organizations such as various chapters of the intergovernmental audit forums. Some RIG officials explained that checklists were not required or provided by headquarters, while others told us that they believed their local versions were more detailed than those provided by their headquarters IGs.

Standardized checklists are important, in our view, because the results of quality control reviews are not comparable among IG regions of a particular agency if their emphasis or format varies. Moreover, we believe that checklists that are annotated to GAGAS make it easier for the RIGs to categorize and analyze the types of problems found in unacceptable audits so that measures can be taken to inform the profession about recurring audit quality problems. At the same time, we would emphasize that the checklist evaluation should not become so routine that the reviewer approaches the task by "checking the boxes." We believe that reviewing audit reports and working papers are processes which require professional judgment by technically skilled reviewers.

When RIGs tie problems in the audit and audit report to specific elements of a standard, we believe that the reviewer is greatly assisted in forming his judgments about the quality of the audit. This extends also to determining whether a standard was actually violated, and if so, the severity of the violation.

During our review, we found that only one of the 25 checklists we examined included annotations to standards and elements of standards for each item on the checklist. Some checklists were written in the language of the standards, but did not either reference the standards or provide detailed explanations of what requirements were necessary to meet each of them. Other checklists recommended that the RIG reviewers become familiar with professional standards, but included no annotated references in case the reviewer needed more detailed explanation. Cross referencing RIG-identified problems to standards would, in our view, help the CPA to better understand the nature of the problems as well as the authoritative criteria used by the RIG.

RIGs Should Consider Taking Actions When Audit Work Is Unacceptable

Currently, the RIGs focus on correcting individual audits when problems are found. We believe that when the RIGs find problems, they should not only have the audit corrected but, depending upon the severity of the problems, consider other actions ranging from a management letter to referral to a regulatory or professional body. Actions taken by the IG would increase the audit community's awareness of the consequences of performing unacceptable work, and should ultimately improve the quality of audits performed of recipients of federal funds.

The actions taken by the RIGs when audits are unacceptable, in our view, should relate to the severity of the problems found. They can range from a letter to the auditor, with a copy to the auditee, suggesting improvement in certain areas, to a recommendation to the grantee or contracting official that the auditor not be considered for future audits. In cases of severe problems—where the CPA neglected to complete much of the work agreed to in the contract, for example—the RIG should consider referring the auditor to regulatory or professional bodies such as the appropriate state board of accountancy and/or the AICPA Ethics Division.

During our review, we ascertained whether the RIGs had policies and procedures for taking action on unacceptable audits and under what conditions actions were taken. In addition, we discussed with RIG officials the effectiveness and practicality of pursuing various actions against CPAs when work was unacceptable.

RIGs Concentrate on Having Audits Corrected

We found that the basic philosophy of most RIGs was to work with the auditor to obtain an acceptable report—even if the acceptable version took months to produce. If the auditor cooperated with the IG and made

the necessary corrections, the IG took no further action, even when the audit was initially unacceptable and the process took long periods of time. We found that the RIGs spent much of their audit quality review time working with CPAs when the CPAs' work was initially deemed unacceptable. Although some auditors were very responsive, we found several examples where the auditors took more than 4 months to satisfy the RIGs' concerns and caused the RIGs to expend resources tracking or re-reviewing auditors' reports. In these cases, we believe the usefulness of a subsequent report diminishes greatly as time passes, especially if the grantee, federal program manager, or the public relied on an earlier incorrect or incomplete version of the audit report.

The following example illustrates these problems:

- In one HUD regional office, the RIG desk reviewed and issued an audit report of a local housing authority in June 1984. The audit report was issued and, shortly thereafter, a quality control review was performed. The RIG stated in a letter to the auditor that there was no evidence in the working papers that the audit was planned and little evidence of a supervisory review by the firm's partner. Also, the RIG stated that it could find no evidence of a study and evaluation of internal controls or evidence that any testing of compliance with laws and regulations was performed. Further, the IG mentioned that the working papers lacked sufficient, competent, evidential matter to support the auditor's opinion on the financial statements. The IG dated this letter September 21, 1984, and asked that the additional documentation be provided within 60 days. The regional IG officials also asked that the CPA inform them if the audit report would be revised based on this additional documentation and/or audit work, and directed that if it was revised, it should be distributed in the same manner as the original report. Seven months later, in April 1985, the requested working papers had not been furnished and the original audit report had not been retracted.

During our work, we inquired into the reasons RIGs are reluctant to consider actions against CPAs. A few RIGs expressed concern about the relatively large amount of resources needed in pursuing measures against CPAs. Others told us that since their mandate is to assure audit quality, they believed that actions against CPAs would create an adversary relationship where a cooperative one was more effective.

We found that several RIGs were reluctant to refer auditors to regulatory and/or professional bodies, such as the state boards of accountancy or the AICPA Ethics Division. Many RIGs explained that although they have

agency guidance which addresses referrals, they seldom need to take this action because CPAs usually make the required adjustments to the audits. A few RIGs are concerned about the resources— especially in regard to documentation requirements—which would have to be devoted to the referral process.

In the AICPA's 1979 study, the agencies submitting audit reports suggested that the AICPA reveal the results of AICPA's individual investigations. The AICPA Ethics Division decided not to share these individual case results with the agencies, and to continue its policy of conducting investigations in confidence, except for trial board results. We believe the policy of not discussing the status of progress of referrals contributes to the IGs' history of infrequent referrals.

A case in the HHS New York region is representative of the types of cases that, in our opinion, should have been referred:

- The RIG quality control reviewed an audit and determined that (1) there was not evidence of proper planning, (2) the audit work was poorly documented, (3) the conclusions lacked sufficient and competent support, and (4) the auditor's working papers provided little evidence that internal control and compliance reviews were made. The RIG rejected the audit after the CPA did not provide the required documentation within the RIG's time frame and informed the grantee that another audit would be required. In response to our inquiry about why the auditor was never referred to a professional or regulatory body, a RIG official told us that he thought rejecting the report was sufficient.

We believe that the RIGs' approach of working with the auditor to make the report acceptable is appropriate when problems are minor. However, we believe that for more serious and recurring problems, the RIG should consider taking further action, even when the auditor is willing to make the corrections necessary to make the audit acceptable.

We believe that by pursuing actions against CPAs when their audits are unacceptable, auditors would become more aware of their professional responsibilities in the performance of governmental audits. We believe that this increased awareness would ultimately improve the overall quality of audits.

Compile, Analyze, and Use the Results of Quality Reviews

We believe the RIGs are missing an opportunity to prevent recurring audit quality problems because they do not record and aggregate the results of their desk and quality control reviews. For the most part, their efforts have focused instead on detecting audit quality problems on a case-by-case basis and working with the CPAs to have the problems corrected. We believe that in addition to detecting quality problems on individual audits, the RIGs could prevent recurring quality problems if they recorded and compiled historic data on each audit firm's performance and analyzed the results of their quality reviews for common trends or patterns.

At the 46 RIG offices, we determined if and how the results of quality reviews were used. Specifically, we wanted to find out

- if the RIGs compile and maintain historic data on audit firms' performance and
- if the RIGs summarize and analyze quality review results for trends or patterns of recurring quality problems.

If the RIGs compiled and maintained a data base containing historic data for each audit firm, they would be able to determine the quality of audit work performed by each audit firm over a period of years. The data base could be used to answer the following types of questions:

- How much experience do the audit firms have in performing financial and compliance audits for the agency?
- How many times have the firms been quality control reviewed?
- Which firms have performed satisfactory work in the past?
- Which firms need more technical assistance to improve their performance?
- Which firms have improved their performance?
- Which firms need to be monitored more closely?
- Which firms have consistently performed unacceptable audit work?

With this information, the RIGs could use their resources more effectively. For example, they could focus less attention on firms that have a history of acceptable work and more on firms with prior unacceptable performance. This information could also be used to track and document unacceptable work when a RIG intends to take actions against a CPA.

In addition to tracking individual firms, the data base would permit the RIGs to aggregate the results of their quality reviews to determine the common problems occurring in the audit reports and in the conduct of

the audits for use in future contracting decisions. For example, the RIGs may find that their guidance is inadequate or unclear. On the other hand, analyses might show that the audit firms were unfamiliar with recent changes in audit requirements or that the RIGs were not putting enough emphasis on certain areas of the audit work. Once the RIGs determined the common types of problems and their causes, they could act to prevent or minimize these problems in the future. The RIGs could clarify guidance, keep the audit firms up-to-date with changing audit requirements, and emphasize areas that need more attention.

RIGs Do Not Compile, Summarize, and Analyze Historic Data on Audit Firms

None of the 46 RIGs systematically compiles and maintains historic data on audit firms' performance from their reviews of audits contracted for by grantees. Seven RIGs that contracted directly with audit firms did keep some data on those audits, but only in order to help them make contract renewal decisions. However, even at these RIGs where the information is collected and used for contracting purposes, the information did not address quality review results related to specific generally accepted government auditing standards.

During our work, we found that some audit firms in our sample contracted to perform audit services for one IG in more than one IG regional office, or for more than one RIG in a particular region. Presently, the RIGs do not share information on the performance of these auditors. We found one instance where the RIG had problems with an audit firm's report. This firm also contracted with another agency in the same region where the RIG also noted problems. We did not track firms' performance in all of the locations, but believe that the RIGs should be aware of a firm's past performance so that the RIGs could more closely monitor these audits.

Several RIGs told us that they believed they did not need to compile and maintain historic data on audit firms. They gave the following reasons for not compiling the data:

- They know who the "problem" auditors are without using a formal system.
- They do not know what the legal ramifications would be if they were to share negative information about an audit firm with other RIG offices.

We believe RIGs should develop a system tailored to their own specific needs. While the RIGs may know who the "problem" auditors are—especially in offices where only a few audit firms are used, we believe RIGs

should not rely on their institutional memory in lieu of documenting quality review results in writing. This becomes even more important when data are sent to headquarters to gain a nationwide perspective about quality problems.

Last, we believe there is precedent for different agency IGs sharing information among themselves on the performance of audit firms. For example, the Southeastern Intergovernmental Audit Forum periodically publishes lists of firms whose work has been quality control reviewed by a particular RIG. Other RIGs may call to discuss an audit firm's performance based on the quality control review results.

We believe that the information on audit firms is readily available in the RIGs' case files since most RIGs document the results of their reviews on a desk review or quality control checklist. The RIGs should develop a system to meet their needs in the least burdensome way.

At the present time, the HHS IG is pilot-testing a computer data base in its Phoenix office that will collect information on types of problems noted during desk reviews. These problems will be coded and will relate to the professional standards for performing the audit. This program is discussed in more detail in the next section.

Headquarters Should Be a Focal Point in the RIGs' Audit Quality Review Process

As we have noted, much of the actual audit quality review function took place in the regional IG offices. Generally, the audit quality review system was decentralized by headquarters IGs to their regional offices. We believe that if headquarters IGs acted as a focal point for gathering regional data on recurring quality problems, the usefulness and integrity of the system would improve greatly.

The headquarters IGs could accomplish two major purposes if they were more involved in monitoring the quality review system. First, where common problems or patterns of deficiencies arose, headquarters could take steps to educate federal program managers, grantees, and auditors so that these problems would not recur with the same frequency. Monitoring the system would also help the IGs remedy any problems stemming from inconsistent or inaccurate guidance provided by them.

Secondly, we believe that if the headquarters IGs obtained, analyzed, and used the regions' quality review results on a consistent basis, the IGs could then periodically inform their agency heads and the Congress on the results of the IGs' nationwide audit quality review efforts. We

believe that this information should include statistical data on the types of audit quality problems found and the recourse taken on substandard audits. It could routinely be included in the IG's semiannual reports to the Congress and would strengthen the agencies' commitment to maintaining a high level of quality among nonfederal auditors.

Current Efforts Underway to Improve Audit Quality Review Systems

Our review of the RIGS' audit quality review systems was made during the period October 1984 through September 1985. During our review, we found that IGS, the President's Council on Integrity and Efficiency (PCIE), the Office of Management and Budget, and the AICPA have initiated efforts to improve audit quality. We believe that several of these efforts were undertaken, in part, because of the Subcommittee's concern about audit quality and its request for our review.

Although some of these efforts contain draft guidelines and one is being pilot-tested, none had yet been fully implemented at the time of our review. Therefore, we cannot comment on the efficacy of these efforts except to say that, in general, they are very constructive and seem to be addressing a number of our recommendations to the inspectors general. These initiatives are consistent with our recommendations for collecting and analyzing results of desk and quality control reviews, considering actions against CPAS, and providing guidance to CPAS.

The following section describes some of these initiatives.

The Department of Health and Human Services—Automated Quality Review System

The HHS IG is developing an automated quality review system to streamline the processing of nonfederal audit reports. The system, currently being pilot-tested in the Phoenix field office, will collect data which can be used for the following purposes:

- managing and controlling the workload;
- maintaining a record of problems with reports by program, auditee, and audit firm;
- providing information that can be analyzed to determine recurring problems encountered with the quality of audits;
- keeping track of the status of audits; and
- providing an up-to-date universe of entities for which HHS is the cognizant agency.

Department of Education—Revisions to Policies and Procedures Regarding Substandard Audit Work

The Department of Education IG is reviewing its policies and procedures for addressing substandard performance by independent auditors, and has proposed new guidelines for referring CPAs to regulatory or professional bodies. Under its old policy, CPAs were not referred to the AICPA's Ethics Division and state boards of accountancy if the auditors corrected the deficiencies within a time frame that the RIG judged reasonable. The IG's proposed revisions provide for correcting some deficiencies without a referral but, also, require the IG to consider other factors in deciding whether to refer a CPA. These factors include the materiality of the deficiencies, whether the audit firm adhered to the program audit guide, whether corrective actions are possible and are made as requested, and whether the deficiency occurred repeatedly. Educations' IG told us that the proposed revisions have been incorporated into its policy and are currently in effect.

AICPA Task Force to Study the Quality of Audits

A task force from the AICPA has been established to study the quality of audits of governmental units. The task force is working through the IGs at the grant-making agencies to obtain information on the results of desk reviews and quality control reviews.

PCIE Revisions to "Orange Book"

As a result of the passage of the Single Audit Act of 1984, the PCIE formed a committee to revise and update the "Cognizant Audit Agency Guidelines" under OMB Circular A-102 (The Orange Book). These guidelines provide guidance for cognizant audit agencies in carrying out their responsibilities under the circular. The revision, issued in October 1985, incorporates changes and new provisions brought about by the act to specify the role of cognizant agencies to fully implement the Single Audit Act. These revised guidelines address many of the objectives for a good quality review system discussed in this report.

OMB Guidelines for IG Development of a Quality Control Program for Single Audits

In September 1985, OMB asked the inspectors general to supplement the provisions of OMB Circular A-128, "Audits of State and Local Governments," by developing a quality control program for single audits. Some of the areas for consideration were:

- desk reviews on 100 percent of the audit reports,
- quality control reviews conducted at least once every 3 years of recipients for which an agency has cognizance,

- quality control reviews on a sample of recipients receiving direct federal funds when there is no agreed upon cognizant agency, and
- states responsible for quality control reviews of recipients receiving all of their federal funds through the states.

State and Local Audit and Accounting Guidance Incorporates the Single Audit Concept

The AICPA's guide for Audits of State and Local Governmental Units, last published in 1975, has been significantly revised. The revised guide will incorporate guidance for the single audit concept based upon the provisions of the Single Audit Act of 1984 and implementing regulations contained in OMB Circular A-128, "Audits of State and Local Governments," issued in April 1985. This merging of guidance will provide comprehensive audits of governmental entities. This guidance, which will be available to the audit community by the end of 1985, is intended to assure the uniform application of audit requirements.

Conclusions and Recommendations for the Statutory Inspectors General

We believe the IGs play a major role in monitoring audit quality and in taking steps to ensure that past recurring problems are corrected. We found that the IGs, on the whole, have identified numerous instances of work that they did not accept. These situations, where CPAs did not perform required audit work, did not adequately document audit work performed, or did not prepare clear audit documentation, warrant the concern of the Congress, the executive branch, and the accounting profession. These results also demonstrate a need for continued and improved monitoring by the inspectors general.

We believe that the importance of audit quality will be underscored as the Single Audit Act approaches full implementation. CPAs will be involved to ensure that federal funds are properly accounted for and that programs are administered in accordance with applicable laws and regulations. It is appropriate now for the IGs and the accounting profession to address those audit quality problems that surfaced during prior CPA audits of federal programs so that the quality problems discussed in this report do not carry over to audits performed under the Single Audit Act.

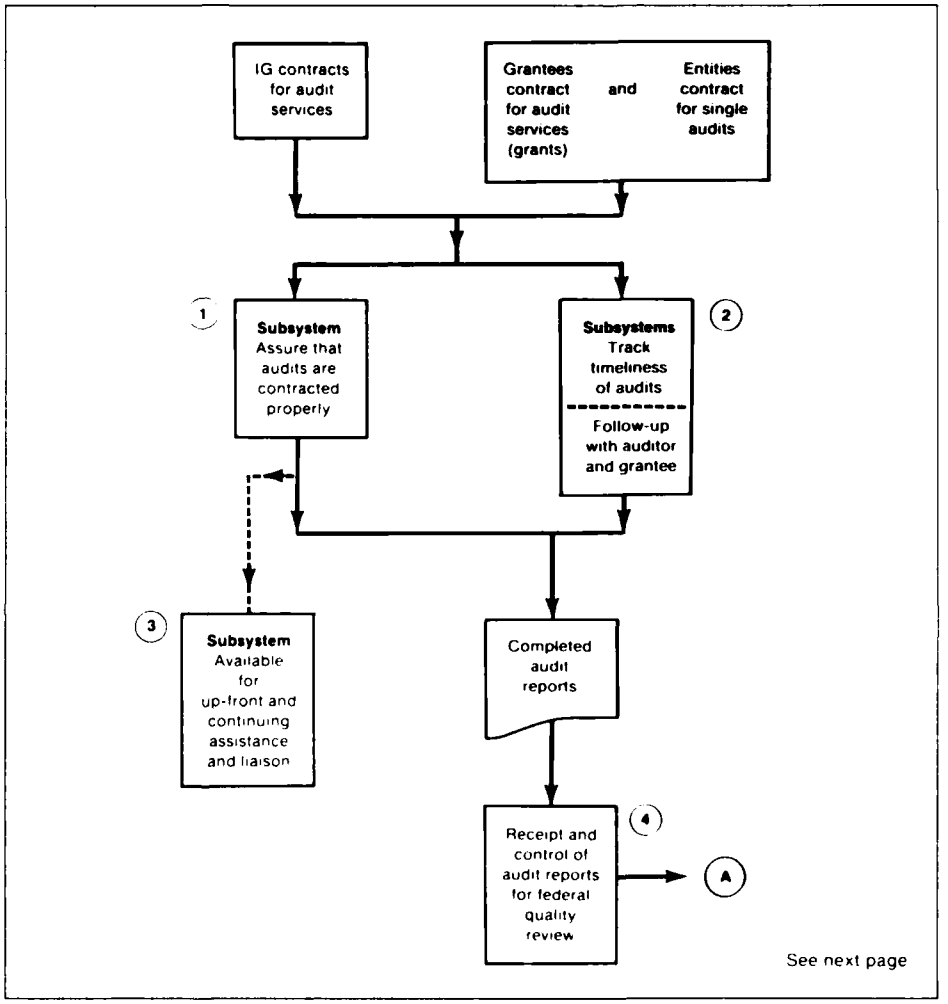
Recommendations to the Statutory Inspectors General

In order to provide a quality control system that adequately identifies, disseminates, and corrects audit problems, we recommend that the statutory inspectors general:

- Prepare and update program audit guides for nonfederal auditors to use in the conduct of their audits. Due to the passage of the Single Audit Act, all audit guides should be reviewed to determine how they can best assist the auditor in performing grant audits that build upon the single audit.
- Develop and require regional inspector general offices to use standardized checklists that are annotated to GAGAS.
- Require all RIGs to conduct quality control reviews on an established percentage of the audit reports they receive.
- Clarify, and where necessary, revise policies on taking actions against CPAs on unacceptable audits, even when the auditor ultimately provides an acceptable report. Policies should also include provisions for referring CPAs to regulatory and professional bodies such as state boards of accountancy and the AICPA, respectively.
- Work with the AICPA and appropriate state boards of accountancy to expedite referrals to these bodies.
- Require regional IG offices to collect, compile, analyze, and use data on the results of their quality control reviews of individual audits to identify and correct trends or patterns of quality problems.
- Require regional IG offices to report quality review results to headquarters using consistent formats and terminology so that nationwide trends and patterns of quality problems can be identified.
- Report problems identified and efforts to improve audit quality to agency heads and to the Congress in their semiannual reports.

Fifteen Elements of an Effective IG Audit Quality Review System

Figure II.1: Securing Audit Services and Reports



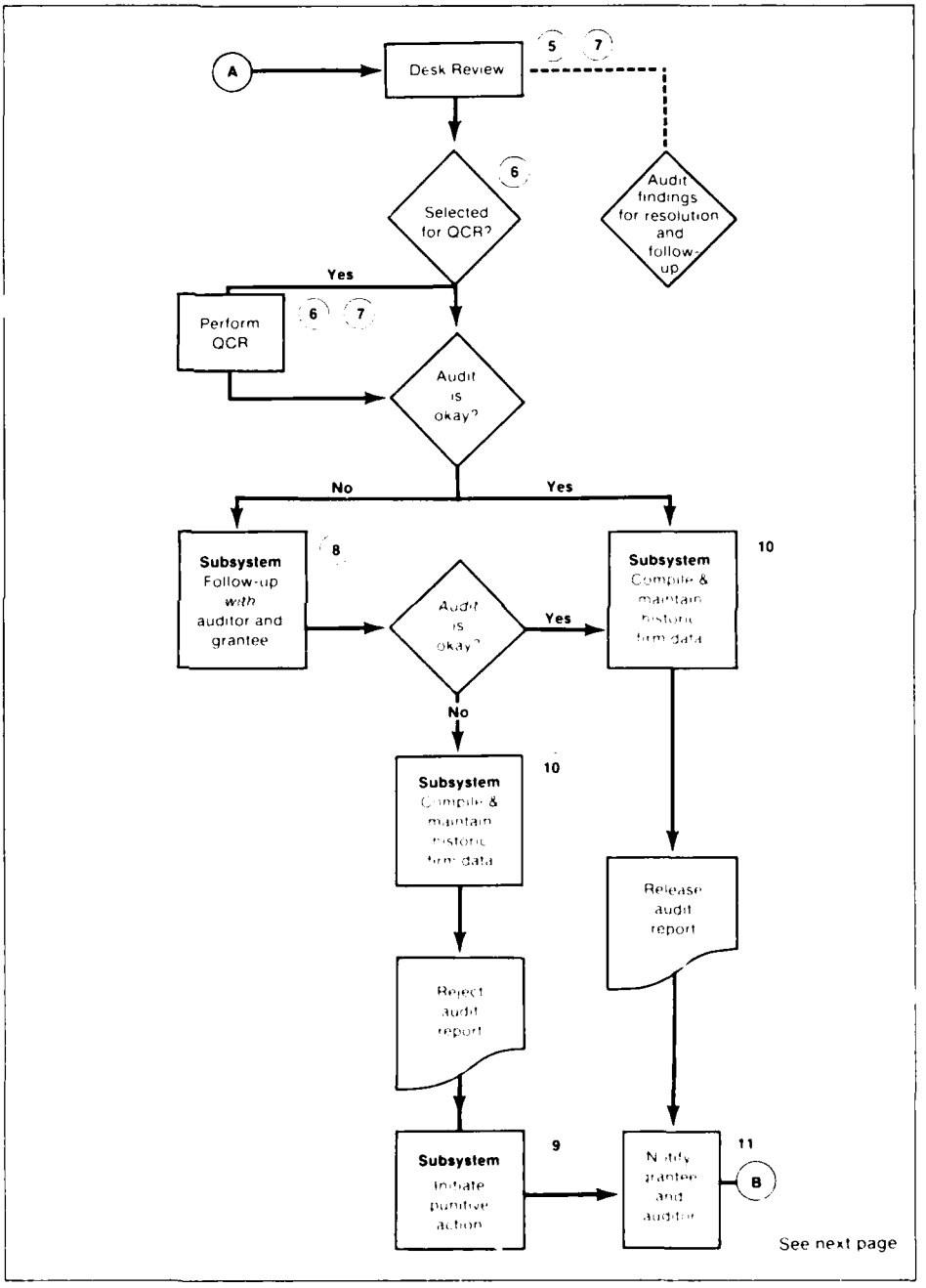
1. IG is involved in assuring that contracts for audit are appropriate and comprehensive.

2. IG assures that the IG office receives all of the audit reports it is supposed to receive, and on a timely basis.

3. Provide accurate and up-to-date guidance for the auditor to use in the earliest stages of the audit engagement.

4. Assure that audit reports are controlled throughout the complete audit review cycle.

Figure II.2: Processing Reports Through Quality Review



5. Conduct a desk review program that assures quality audit reports and identifies report findings for audit resolution.

6. Conduct a quality control review program that assures audits are performed in accordance with professional standards.

7. Use standardized review checklists, tied to professional standards, to perform desk reviews and quality control reviews.

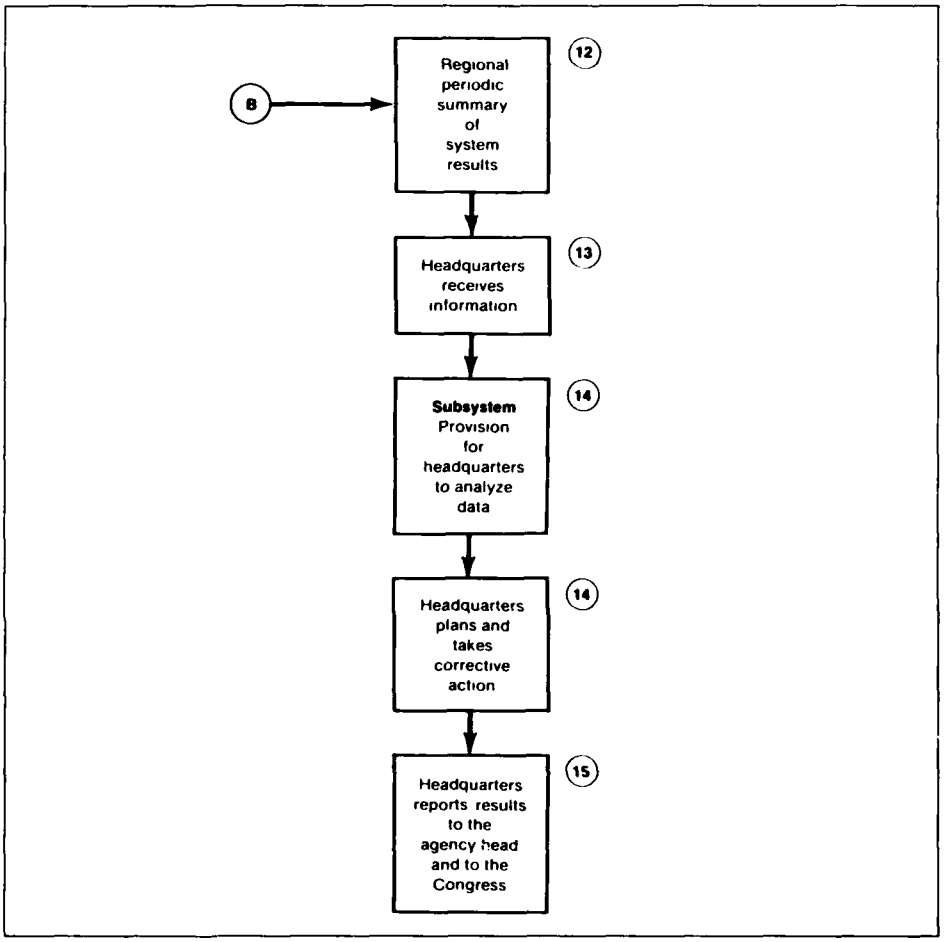
8. Communicate with the auditor and grantee to correct noted deficiencies, using procedures established by the headquarters IGs.

9. Assure that appropriate sanctions are taken when severe problems are noted. This should include requirements for documenting action taken.

10. Compile and maintain historic data on audit firms on both issued reports and unacceptable audits.

11. Inform both the grantee and auditor of quality review results on both issued reports and unacceptable audits.

Figure II.3: Using Quality Review Results



12. Record and summarize quality review results at the regional level.

13. Consistently and accurately report quality review results to the headquarters IGs.

14. Analyze and use quality review results on a nationwide basis.

15. Report nationwide results of quality reviews to the agency head and to the Congress.

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