Chapter 16

Auditing Governmental and Nonprofit Organizations

Learning Objectives

LO1 Compare and contrast the goals of auditing for-profit entities with those of government and nonprofit entities.

LO2 Identify and understand the rationale for the additional standards applicable to financial statement audits using generally accepted government auditing standards (GAGAS).

LO3 Classify other types of assurance and attestation engagements applicable to government and nonprofit entities.

LO4 Understand the purpose of and developments associated with the Single Audit Act of 1984 and Uniform Guidance.

LO5 Explore special topics as they relate to audits of government and nonprofit entities.

Road Map

LO	Learning Objective | Topics	Page	eLecture	Guided Example	Assignments
16-1	Compare and contrast the goals of auditing for-profit entities with those of government and nonprofit entities.	16-3	16-1	16-1	Q1, 2; E44
16-2	Identify and understand the rationale for the additional standards applicable to financial statement audits using generally accepted government auditing standards (GAGAS).	16-5	16-2	16-2	Q3, 4, 5, 6, 7, 8, 9, 10, 11; MC21, 22, 23, 24
16-3	Classify other types of assurance and attestation engagements applicable to government and nonprofit entities.	16-16	16-3	16-3	Q12; MC25, 26, 27
16-4	Understand the purpose of and developments associated with the Single Audit Act of 1984 and Uniform Guidance.	16-18	16-4	16-4	Q13, 14, 15, 16; MC28, 29, 30, 31, 32, 33, 34; E41, 42, 43, 45
16-5	Explore special topics as they relate to audits of government and nonprofit entities.	16-24	16-5	16-5	Q17, 18, 19, 20; MC35, 36, 37, 38, 39, 40; E46

INTRODUCTION

A financial statement audit provides assurance to a wide range of stakeholders, and the principles and standards for conducting audits have evolved over time, sometimes rapidly in response to crises (e.g., the case of Arthur Andersen in 2002 [1]) and gradually at other times. Fundamentally, the audit lends credibility to the company it audits, by providing assurance that its financial information is fairly presented. Financial information, prepared solely by the company and without such assurance, would be less credible to a company's external stakeholders.

The evaluation of an audit by a company's stakeholders, however, should be undertaken with an understanding of the incentives of the audit client and audit firm. External stakeholders expect auditors to possess the expertise necessary to be able to detect any material misstatements. Auditors must also be capable of being objective and independent in reporting material misstatements. The inherent challenge is that audit firms are engaged and paid by their clients, and audit clients may differ in their desire for a rigorous audit. Audit firms may face pressure by their client to report favorable audit results when audit testing warrants less favorable results. The divergence between the goals of external stakeholders (a rigorous, high-quality audit) and the goals of the audit client (favorable results) may be further complicated by audit market constraints. For example, in some industries, the number of audit firms capable, available, and willing to perform audits is constrained. Under these circumstances, qualified audit firms may be subject to weaknesses due to workload compression, in other words, too many audits to complete in a short period of time. Furthermore, firms lacking experience in a specific industry may be selected to conduct audits that would be better left to firms with more expertise and training.

Auditing government and nonprofit entities requires specialized knowledge and expertise, and constraints exist in the supply of firms capable, available, and willing to perform these audits. The case of the City of Dixon, Illinois, in which a city controller/treasurer stole more than $53 million over a 20-year period, is an example of a fraud that went undetected by the audit firms engaged to conduct the audit. The failure to detect the fraud by the audit firm engaged at the time of detection was noted to have very little expertise in municipal auditing. Undetected by the audit firm, the fraud was only discovered by another employee when the controller/treasurer took an extended vacation in 2011.[2] Understanding this specific audit environment is important for those who may audit government and nonprofit entities, those who may work directly for these entities, and for every accounting and public administration professional in their roles as citizens, volunteers, and participants in the governance process for these entities. In this chapter, we will explore the unique aspects of government and nonprofit audits, including the single audit, which is required when government and nonprofit entities expend more than $750,000 of federal grant awards. Government and nonprofit audits have unique market characteristics and other constraints that may threaten audit quality; they are also subject to cognitive biases that threaten sound, objective, and independent audit judgment and decision-making.

Photo by Jack Hughes

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[1] The Sarbanes-Oxley Act of 2002. P.L. 107-204, also known as the Public Company Accounting Reform and Investor Act, was passed in response to several corporate scandals, including Enron and its auditing firm, Arthur Andersen LLP. The act included additional requirements for auditor independence and evaluation of internal controls by the auditor.

[2] Believed to be the largest theft of public funds in the United States to date, the case involved long-time comptroller/treasurer Rita Crundwell stealing more than $53 million over a 20-year period. When Crundwell took an extended vacation in 2011, the city clerk discovered a bank account that Crundwell had been using to divert city funds to herself. In 2013, Crundwell was sentenced to just under 20 years in federal prison after pleading guilty in 2012. Crundwell worked for the City of Dixon from 1970 to until 2011 when the fraud was discovered (U.S. Department of Justice 2013).

Chapter Organization

Auditing Governmental and Nonprofit Organizations

Goals of Auditing Governmental and Nonprofit Entities	Understanding Generally Accepted Government Auditing Standards	Other Types of Assurance and Attestation Engagements for Government and Nonprofit Entities	Uniform Guidance Audits (Commonly Referred to as Single Audits)	Special Topics Applied to Government and Nonprofit Auditing
■ Similarities with for-profit audits ■ Differences from for-profit audits	■ Requirements of AICPA GAAS in a Financial Statement Audit ■ Applicability of GAGAS versus GAAS ■ How GAGAS Have Evolved ■ Requirements of GAGAS in a Financial Statement Audit ■ Other GAGAS Requirements Applicable to a Financial Statement Audit ■ GAGAS Audit Report	■ Performance Audits ■ Attestation Engagements	■ Purpose of the Uniform Guidance Audit ■ Key Developments of the Uniform Guidance Audit ■ Requirements of a Uniform Guidance Audit ■ Uniform Guidance Audits and Federal Audit Clearinghouse (FAC) Submissions ■ Uniform Guidance Audit Findings ■ Uniform Guidance Audit Quality	■ Rational Decision-Making and Cognitive Biases ■ Special Purpose Frameworks and the Conducting of an Audit

Goals of Auditing Governmental and Nonprofit Entities

eLectures MBC **LO1** Compare and contrast the goals of auditing for-profit entities with those of government and nonprofit entities.

Audits provide important information to stakeholders of the entities subject to audit. For publicly traded companies, audits provide assurance that helps shareholders evaluate the risks associated with their investments and provide information to creditors responsible for evaluating default risk. Similarly, audits of governmental and nonprofit organizations provide assurance to external stakeholders, including taxpayers, donors, bondholders, credit ratings agencies, and other creditors.

Some financial statement line items are similar across organization types and may even call for a similar audit approach. For example, accounts receivable, net of the allowance for doubtful accounts, in a for-profit entity might be tested by sending confirmation letters to the customers from which amounts are owed, and by evaluating whether the allowance account is sufficient. Similarly, an auditor might test the existence of taxes receivable of a government entity with confirmation letters to significant taxpayers and test the existence of contributions receivable of a nonprofit entity with confirmation letters to significant donors.[3] In addition, auditors of government and nonprofit entities also test the adequacy of the allowance accounts associated with receivables (for governments, taxes receivable, and for nonprofit organizations, contributions receivable).

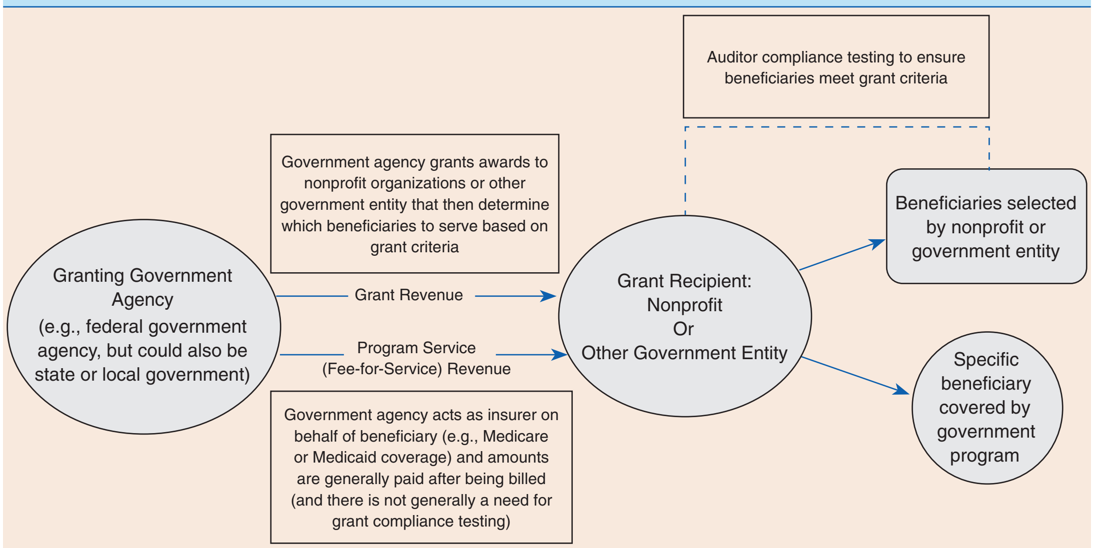
The absence of equity shareholders does not negate the need for assurance on the financial statements; however, the emphasis on goals other than profit, such as providing services to the citizenry

[3] Note that the usefulness of this approach to testing the existence of receivable amounts would be strengthened in the case of taxpayers or donors with significant receivable amounts.

(governments) and pursuing a social mission (nonprofit entities), does increase the scope of a financial statement audit in this setting. In addition to audit work related to the basic financial statements, auditors are also responsible for evaluating compliance with laws, regulations, and grant requirements. State and local governments provide services using taxpayer-provided resources, either assessed directly by the government or provided by grants from higher levels of government where taxes were originally assessed (e.g., a city receives state or federal grants, or a state receives federal grants). Similarly, nonprofit organizations receive significant government support, with the Urban Institute reporting that public charities attribute almost one-third of their support to governments—government grants (8.3%) and government contracts (23.9%).[4] The use of significant government resources, either by a state or local government or a nonprofit entity, extends the scope of an audit beyond consideration of the basic financial statements.

Government grants, in particular, are often said to come with "strings attached." Government grants are awarded with stipulations on the types of services provided and which beneficiaries will be served with the grant money. This contrasts with government-provided fee-for-service, or program revenues, such as Medicare and Medicaid revenues which function as insurance for individuals meeting certain age, disability, and/or income criteria. In contrast with Medicare or Medicaid revenue where a county or nonprofit hospital would bill for services provided to a specific patient for whom eligibility has already been determined, government grants are awarded in anticipation of the government or nonprofit providing services to beneficiaries (individuals or organizations) that meet certain grant eligibility requirements. It is this characteristic of government grants that makes compliance testing a necessary part of the audit, as depicted in **Figure 16-1**.

FIGURE 16-1 ■ Distinguish between Government Grants and Program Service Revenue



Compliance testing requires governmental and nonprofit financial statement auditors incorporate testing of specific grant criteria as well as limitations on special-purpose taxes and similar revenues. Furthermore, compliance testing includes consideration of broader compliance with laws and regulations applicable to government and nonprofit entities. For example, an audit of a government may include testing associated with the entity's process for awarding contracts and use of a competitive bidding process. As part of the testing of compliance with laws, regulations, and specific grant criteria, auditors must also separately consider internal controls over the management of grant awards, which generally have processes and reporting distinct from financial reporting.

In many instances, government grants are the impetus for the audit. In other words, governments and nonprofit entities might not be subject to the audit, except through the presence of one or more grants. In these audits, the processes for communicating and reporting audit results may extend beyond what would be expected in the audit of a for-profit entity. When federal government grants are involved, there are additional special considerations and filing requirements.

[4] Sarah L. Pettijohn, *The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering, 2013* (Washington, DC: The Urban Institute, 2013).

In addition to the possibility of an expanded scope financial statement audit (incorporating compliance testing), government and nonprofit entities may also be subject to other types of audits and engagements that require the special skills of an external audit firm or government audit agency. In this chapter, we will explore attestation engagements that require auditors or government audit agencies (state auditors) to apply procedures to evaluate and review internal controls, compliance, contracting, or other special reports including those related to tax-increment financing. We will also discuss another type of audit provided in these sectors—performance or operational audits. Designed to identify areas for improved efficiency and effectiveness, performance audits may be conducted by external audit firms or centralized government audit agencies and offer tremendous potential benefits for the audited entity.

Review 16-1 LO1

GuidedExamples MBC

Following is an excerpt from the audit report for the Boys and Girls Clubs of America for the fiscal year ended December 31, 2017: "In accordance with Government Auditing Standards, we have also issued our report dated August 24, 2018 on our consideration of Boys and Girls Clubs of America and its subsidiaries' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters."

Required:
Based on the audit report excerpt (above), explain the difference between the scope of a financial statement audit of a for-profit entity and a nonprofit entity such as the Boys and Girls Clubs of America that receives government grants.

Solution on p. 16-34.

Understanding Generally Accepted Government Auditing Standards

eLectures MBC **LO2** Identify and understand the rationale for the additional standards applicable to financial statement audits using generally accepted government auditing standards (GAGAS).

Requirements of AICPA GAAS in a Financial Statement Audit

Generally accepted auditing standards (GAAS) are established by the American Institute of Certified Public Accountants (AICPA) Auditing Standards Board (ASB) to direct the performance of financial statement audits of a wide range of entities.[5] The ASB issues Statements on Auditing Standards (SASs) which are then codified into the AICPA Codification of Statements on Audit Standards sections. GAAS prescribe the broad objectives of the auditor and the conduct of an audit, as well as specific requirements related to planning, audit evidence, and reporting. Ultimately, GAAS require an evaluation of whether the audit client's financial statements conform with generally accepted accounting principles (GAAP), such that an opinion can be stated (or that an opinion is disclaimed due to limitations in the audit).

Applicability of GAGAS versus GAAS in Financial Statement Audits

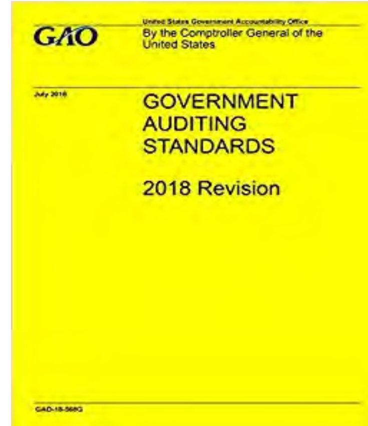
Governments, nonprofits, and even companies that receive financial support from government grants or contracts may require an expanded scope audit based on generally accepted government auditing standards (GAGAS) rather than a GAAS audit. In fact, it is common for state and local governments to be subject to a GAGAS audit even when they do not receive grants from other governments.[6] Commonly referred to as "Yellow Book" (because of the color of its cover), GAGAS are produced by the U.S. Government Accountability Office (GAO). GAGAS generally include all AICPA GAAS as well as additional standards that address the unique facets of auditing when government funding is involved.

The GAO first issued GAGAS, although not formally named that at the time, in 1972. Since then, the GAO has updated these standards periodically to consider changes in the governmental environment.

[5] In 2002, the Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB), which it charged with establishing auditing standards to be used by CPAs who audit public companies.

[6] The National Association of State Auditors, Comptrollers and Treasurers (NASACT) conducts an annual survey of audit requirements by state. In its 2016 "Auditing in the States," NASACT reports that 13 states require the use of GAGAS for conducting the audits of local governments.

The GAO standards have also changed to create “harmonization” between GAGAS and GAAS established by the American Institute of Certified Public Accountants (AICPA). The GAO has produced seven updates to GAGAS since their initial issuance, with the most recent revision in 2018 (the 2018 Yellow Book). That revision is effective for audits of financial statement periods ending on or after June 30, 2020.



A wide range of laws, regulations, contracts, and grant provisions may require or encourage an entity to have a GAGAS audit. Federal legislation requires many federal agencies to have a GAGAS audit. State and local governments and other entities that accept federal awards, particularly at the level that would trigger a Uniform Guidance audit (discussed in the Learning Objective 16-3), must also have a GAGAS rather than a GAAS audit. In addition, every U.S. state has laws that address which standards, GAAS or GAGAS, must be used to conduct audits of governments (and occasionally nonprofit organizations) within its jurisdiction. For example, legislation in the State of Tennessee requires each government entity in its jurisdiction to have an audit:

> (a) It is the duty of each political subdivision, special taxing district, board, commission, educational cooperative, intergovernmental cooperative or other governmental agency, including, but not limited to, municipal corporations, utility districts, school boards, and housing authorities created under the Housing Authorities Law, compiled in title 13, chapter 20, part 1, with respect to all funds under its control, to order and pay for such audit and any other audit which it is required to perform under state law, and to contract with certified public accountants, public accountants, or other department of audit to make such an audit.[7]

Tennessee legislation also requires audits to be conducted in accordance with GAGAS (not GAAS) and requires financial statements to be prepared using generally accepted accounting principles (GAAP):

> (d) The comptroller of the treasury, through the department of audit, shall be responsible for determining that such audits are prepared in accordance with *generally accepted governmental auditing standards* [emphasis added] and that such audits meet the minimum standards prescribed by the comptroller. The comptroller shall promulgate such rules and regulations as are required to assure that the books and records are kept in accordance with *generally accepted accounting principles* [emphasis added] and that audit standards prescribed by the comptroller of the treasury are met.[8,9]

Even when not required to have a GAGAS audit, governments and nonprofit entities, as stakeholders, may conclude that the expanded scope of GAGAS audits offers more assurance that financial statements are fairly stated.

How GAGAS Have Evolved

Over time, GAGAS have evolved in response to changes in the government and nonprofit environment, but also to changes in the for-profit environment as reflected in AICPA GAAS. As noted earlier, GAGAS (also the Yellow Book) were revised in 2018 from the previous Yellow Book version issued in 2011. Although the basic standards and principles are similar, the 2018 Yellow Book includes some noteworthy changes. Most significantly, the 2018 Yellow Book moves application guidance previously provided in its appendixes into the chapters of the book to help GAGAS auditors to better implement its standards. In addition, the 2018 Yellow Book provides more emphasis for some of the more challenging independence issues, updates peer review standards to accept other audit organizations’ programs for peer review, provides a formal definition of “waste,” and expands the GAO’s focus on internal controls in performance audits.

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[7] Tennessee Code Annotated §9-3-212.

[8] Ibid.

[9] The National Association of State Auditors, Comptrollers and Treasurers (NASACT) produces a publication each year titled “Auditing in the States.” This publication identifies which standards (GAAS or GAGAS) must be used in conducting audits of local governments.

Requirements of GAGAS in a Financial Statement Audit

The basic tenets present in GAAS are also present in the 2018 Yellow Book, and there are numerous references in GAGAS to the AICPA's Statements on Auditing Standards (SAS). Chapter 6 of the 2018 Yellow Book provides the standards for financial statement audits and explicitly incorporates AICPA GAAS. Although GAGAS does not explicitly incorporate the AICPA's Code of Professional Conduct, its elements—in particular, ethics and independence—generally apply.

Chapter 6 of the 2018 Yellow Book includes nine requirements for conducting financial statement audits and seven requirements for reporting on financial statement audits, as shown in **Table 16-1**.

TABLE 16-1 Generally Accepted Government Auditing Standards (2018 Yellow Book) Requirements for Conducting Financial Audits

	Yellow Book Chapter and Sections
Compliance with Standards	6.02–6.03
Licensing and Certification	6.04–6.05
Auditor Communication	6.06–6.10
Results of Previous Engagements	6.11
Investigations or Legal Proceedings	6.12–6.14
Noncompliance with Provisions of Laws, Regulations, Contracts, and Grant Agreements	6.15–6.16
Findings	6.17–6.30
Audit Documentation	6.31–6.33
Availability of Individuals and Documentation	6.34–6.35

The *Compliance with Standards* section requires auditors to consider both GAAS and GAGAS in conducting an audit and suggests that lower materiality amounts may be appropriate due to the need for public accountability. *Licensing and Certification* requirements include being a licensed CPA or working for a licensed CPA firm, unless the auditor works for a government audit organization, such as a State Audit Agency. as it is common in some states to have a centralized government agency to audit certain types of state and/or local government entities.[10] *Auditor Communication* requirements delineate the extent to which and manner by which auditors should communicate with individuals and entities responsible for requesting or requiring the audit. Requirements related to *Results of Previous Engagements* require that auditors evaluate prior audits and other engagements for results that may have bearing on the current year audit.

The *Investigations of Legal Proceedings* section requires auditors to both inquire of any investigations in which their clients are involved that affect the period under audit. The *Noncompliance with Provisions of Laws, Regulations, Contracts, and Grant Agreements* section requires the auditor to consider noncompliance and provides application guidance to assist in evaluating compliance. The *Findings* section requires that auditors fully understand the cause and effect of audit findings, including the role of the internal control system in contributing to the findings. Beyond what would be required in a financial statement audit of a for-profit entity, the 2018 Yellow Book suggests that auditors consider the effectiveness of the auditee's internal controls in minimizing "waste" and "abuse," with definitions of each provided. The *Audit Documentation* section requires supervisory review be documented, as well as identification of any instances in which GAGAS requirements were not strictly followed. The *Availability of Individuals and Documentation* section governs how auditors should make certain information and individuals from the audit team available to others.

[10] The National Association of State Auditors, Comptrollers and Treasurers (NASACT), "Auditing in the States," identifies the states that have a centralized audit agency; nearly all states have elected or appointed state auditors. Their offices may supervise and have administrative rights over the accounting and financial functions of the state as well as the governments and some nonprofit entities within their jurisdictions.

Other GAGAS Requirements Applicable to a Financial Statement Audit

Chapters 1 through 5 of the 2018 Yellow Book provide other principles for conducting audits and other engagements, including financial statement as well as other types of audits, of government and nonprofit entities. (See **Table 16-2** below.) Throughout, there is an emphasis on accountability, which the GAO describes as "key to our nation's governing processes."[11] The audit is viewed as a tool for ensuring accountability, provided to those who conduct these audits, including CPA firms, federal inspectors general, federal internal auditors, municipal auditors, state auditors, and supreme audit institutions (such as the GAO).

While Yellow Book Chapters 1 through 5 relate to the full complement of audits and attestation engagements, certain elements are particularly relevant to the financial statement audit. For example, Chapter 2 requires auditors to explicitly cite GAGAS in their audit report as the basis for conducting the audit, even when other standards are also used.

TABLE 16-2 ■ Generally Accepted Government Auditing Standards (GAGAS) Contents of Chapters 1 through 5

Chapter 1 . . .	Foundation and Principles for the Use and Application of Government Auditing Standards
Chapter 2 . . .	General Requirements for Complying with Government Auditing Standards
Chapter 3 . . .	Ethics, Independence, and Professional Judgment
Chapter 4 . . .	Compentence and Continuing Professional Education
Chapter 5 . . .	Quality Control and Peer Review

The 2018 Yellow Book Chapter 3 discusses the principles associated with ethics, independence, and professional judgment. Notably, auditors are cautioned to only take on work that they are competent to perform. As noted later on page 16-23, the fact that audit quality concerns are significant in this market makes it necessary for the Yellow Book to discuss competence as part of the ethical principles of GAGAS. The concept of accountability is fundamental to the discussion of ethical principles as well, given the public's reliance on the audit. Similarly, Chapter 3 of the 2018 Yellow Book emphasizes the importance of objectivity and a nonpartisan and nonideological approach to conducting an audit. Under the broad heading of integrity, the standards acknowledge that auditors may encounter programs with which their own personal ideology differs; in this case, the expectation is that auditors will act with integrity.

Independence

Chapter 3 of the 2018 Yellow Book addresses independence, a concept that is often more easily defined than it is applied. The requirements state, "In all matters relating to the GAGAS engagement, auditors and audit organizations must be independent from an audited entity."[12] The application guidance states that independence should be in both mind and appearance, consistent with GAAS. The value of a GAGAS audit is compromised if readers of the audit report, including the general public, perceive a lack of independence. Some independence threats are consistent with GAAS audits of for-profit entities, including audit firm dependence on the fee revenue from the engagement, a member of the audit team being hired by the client, and direct financial interests in the auditee.

Also similar to GAAS audits, auditors must conduct independence reviews to ensure that the firm or its personnel are not participating in their client's management functions, such as making decisions about accounting. In addition, many nonaudit services are prohibited because they threaten independence. The GAGAS auditor can provide some types of guidance and advice if the activities are routine and informal. However, the 2018 Yellow Book identifies specific activities that are not considered to be routine, including financial statement preparation. For some clients, particularly those that are smaller with a limited number of accounting and finance staff, having the auditor prepare the published financial statements may seem like a logical choice—the client leaves the financial statement preparation to the auditor who may have more expertise in compiling statements and may do so

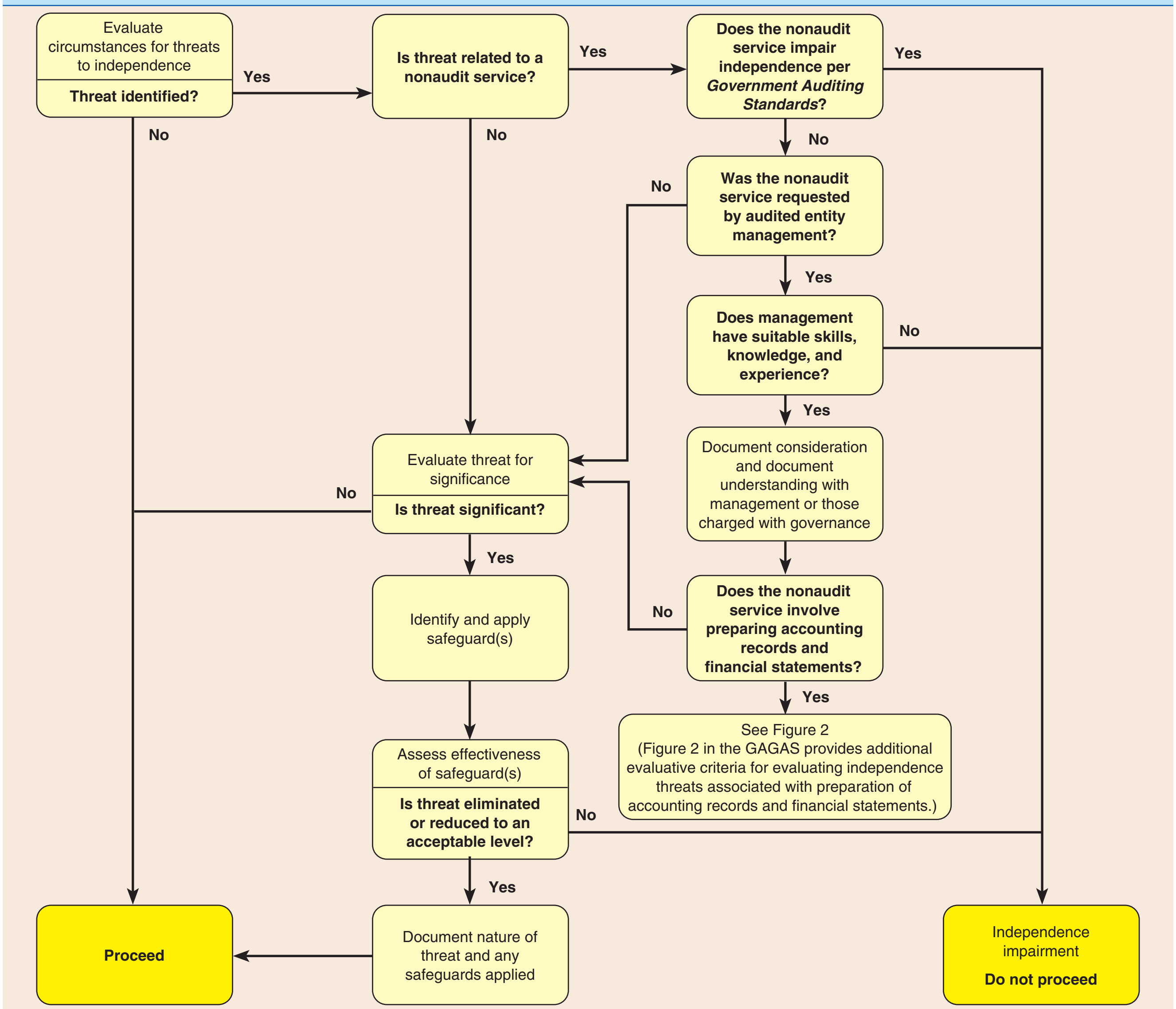
[11] U.S. Government Accountability Office (GAO) Government Auditing Standards: 2018 Revision, page 3. Washington, DC: GAO.

[12] U.S. Government Accountability Office (GAO) Government Auditing Standards: 2018 Revision, page 29. Washington, DC: GAO.

more efficiently. However, GAGAS identify this practice as a significant independence threat, and, although permitted in some circumstances, it is permitted only after careful deliberation by the auditor.

The 2018 Yellow Book requires that if threats to independence cannot be eliminated entirely, they must be addressed with safeguards that reduce the threat to an acceptable level. **Figure 16-2** is provided in Chapter 3 of 2018 Yellow Book. It is intended to help GAGAS auditors evaluate independence threats. Any evaluation of independence threats that require safeguards must be documented by the auditor. In the case of the preparation of financial statements, safeguards may include: (1) conducting the preparation only from a client-prepared trial balance, (2) ensuring that the client agrees with any aggregation decisions in the preparation of the statements (i.e., accumulating accounts to present in one line item in the financial statements), and (3) ensuring that the client has the capability of overseeing the preparation of their financial statements. To this latter point, when a governmental entity engages an auditor to prepare its financial statements because it is unable to do so, management clearly does not possess the capability—or skills, knowledge, and experience (SKE)—and the auditor is clearly acting in a management capacity.

FIGURE 16-2 ■ **2018 Yellow Book Conceptual Framework for Independence**



Source: GAO. GAO-18-568G.

Professional Judgment

Chapter 3 of the 2018 Yellow Book addresses another conceptually straightforward, but practically challenging, concept—professional judgment. The two elements of professional judgment include reasonable care and professional skepticism. Reasonable care involves "acting diligently in accordance with applicable professional standards and ethical principles."[13] Professional skepticism involves having "a questioning mind, awareness of conditions that may indicate possible misstatement owing to error or fraud, and a critical assessment of evidence."[14] Professional judgment, encompassing these two concepts of reasonable care and professional skepticism, then requires a requisite level of skills as well as the ability to be objective. The latter is particularly challenging given human decision-making, which is prone to include preconceived ideas and biases (see Learning Objective 16-5). In the quest to be neutral and skeptical of information that is presented, auditors must therefore be aware of areas in which they will be susceptible to influence and work to seek out and evaluate audit evidence that may not support their expectations.

Competence and Training

Chapter 4 of the 2018 Yellow Book presents the requirements for competence and training. Fundamentally, audit managers should work to assign auditors to engagements who possess the necessary knowledge and skills to be able to competently perform the audit. Practically speaking, this is every audit firm's challenge—recruiting, hiring, developing, and retaining personnel who are competent and who know when to seek out guidance (that is, understanding the limits of their own knowledge base). For firms with GAGAS clients, this is particularly critical.

The knowledge base needed for GAGAS audits led the GAO to include a specific training requirement for auditors who are involved in GAGAS audits. In every two-year period, these individuals must complete continuing professional education (CPE). Of the hours completed (generally an average of 80 in two years), 24 must be "directly related to the government environment, government auditing, or the specific or unique environment in which the audited entity operates."[15] GAGAS also require a minimum of 20 hours of CPE annually and that training records be maintained. The application guidance provided in the 2018 Yellow Book should assist audit firms in ensuring that the types of CPE (both content and delivery) are appropriate and determining how to monitor and document CPE.

PROFESSIONAL JUDGMENT AND COMPETENCE

The ability to exercise professional judgment requires competence, and GAGAS are designed to ensure both. In the fraud cited earlier in the City of Dixon, Illinois, two audit firms were held responsible for failing to detect the crime, with judgments ordered of the two firms totaling more than $36 million.

Source: *Chicago Tribune*, September 25, 2013.

Quality Control and Peer Review

GAAS require quality control and peer review (AU-C Section 220). Similarly, the 2018 Yellow Book requires organizations conducting GAGAS audits to establish a quality control system designed to ensure compliance with professional standards and to document the system's policies and procedures. The policies and procedures should be communicated with audit organization personnel and should specifically address:

- Leadership responsibilities (Sections 5.05 and 5.06);
- Independence, legal, and ethical requirements (Sections 5.08 and 5.09);
- Initiation, acceptance, and continuance of engagements (Section 5.12);
- Human resources (Sections 5.15 and 5.16);
- Engagement performance (Sections 5.22 through 5.25); and
- Monitoring of quality (Sections 5.42 through 5.46)

[13] U.S. Government Accountability Office (GAO) Government Auditing Standards: 2018 Revision, page 58. Washington, DC: GAO.
[14] U.S. Government Accountability Office (GAO) Government Auditing Standards: 2018 Revision, page 58. Washington, DC: GAO.
[15] U.S. Government Accountability Office (GAO) Government Auditing Standards: 2018 Revision, page 67. Washington, DC: GAO.

The 2018 Yellow Book includes specific requirements for audit firms to undergo external peer review. Peer review is part of the quality control process and requires an outside organization to evaluate the work of the audit organization. GAGAS requirements identify several organizations, including the AICPA, with which an audit organization may be affiliated, and if so, should comply with that organization's peer review requirements. Even if not affiliated with the AICPA or the other GAGAS-recognized organizations, all audit organizations conducting GAGAS audits must meet the 2018 Yellow Book peer review requirements.

The audit organization may choose its peer review team, but the review team must have competence in GAGAS audits as well as in peer reviews. It must be independent of the reviewed audit organization. The peer review team must evaluate all of the reviewed audit organization's types of engagements, and peer reviews should be conducted at least every three years. The peer review team will use the following ratings in its report of the reviewed audit organization's engagements:

- Pass
- Pass with deficiencies
- Fail

The peer review will then be made publicly available, and in application, the 2018 Yellow Book recommends that the peer review process is described in the report to make it easy for the general public to understand.

AUDITING IN PRACTICE

For the peer reviews of government audit agencies, the public dissemination of the peer review report can be made through another government. For example, the State of Tennessee Office of the Comptroller of the Treasury Department of audit, responsible for auditing state agencies, provides its peer review results on its website. For the fiscal year ended June 30, 2018, the State of Tennessee reported the following:

Peer Review

The Department of Audit undergoes an external review of its quality control system every two years. Section 8-4-102, Tennessee Code Annotated, states:

> Previous to the convening of each biennial general assembly, the speaker of the senate and the speaker of the house jointly may contract for the services of an independent public accounting firm to audit or review the operations of the office of the comptroller, or may call upon the director of the division of state audit to review with them a current audit of the comptroller of the treasury. The speakers may appoint a committee of the general assembly for the purpose of such review.
>
> The Speakers directed the Department of Audit to undergo a quality assessment review under the auspices of the National State Auditors Association. The most recent review was performed in August 2018 by certified public accountants from the staffs of several local, state and federal audit organizations as well as other professionals holding executive level posts in federal and state governments. The purpose of the review was to ensure that the department is meeting its responsibility to perform audit work in accordance with government auditing standards generally accepted in the United States of America. The report of the peer review for the year ended June 30, 2018, rendered an unmodified opinion on the department's system of quality control. In the opinion of the quality assessment team, "the system of quality control of Tennessee Comptroller of the Treasury, Department of Audit in effect for the period July 1, 2017 through June 30, 2018 has been suitably designed and was complied with during the period to provide the audit organization with reasonable assurance of performing and reporting in conformity with *Government Auditing Standards* in all material respects. Audit organizations can receive a rating of pass, pass with deficiency(ies), or fail. The State of Tennessee, Office of the Comptroller of the Treasury, Department of Audit has received a peer review rating of pass." The next peer review is scheduled for July 2020.
>
> To view a copy of the National State Auditors Association opinion on the department's system of quality control in effect for the year ended June 30, 2018, see the following: **https://www.comptroller.tn.gov/content/dam/cot/sa/documents/TNPeerReviewReport2018.pdf**.

GAGAS Audit Report

The outcome of the financial statement audit is an audit report that stakeholders may use to discern whether and to what degree to rely on the financial statements of the audited entity. This is true for all types of audited entities, and the most important element of the audit report is the type of opinion issued. The types of opinions that may be issued in these reports are therefore similar across entity types—either ***unmodified*** (i.e., clean) or ***modified***, where the distinction is then made that the opinion is ***qualified***, ***adverse***, or cannot be determined (i.e., ***disclaimer of opinion***). A qualified audit report is issued when there are material misstatements to the financial statements, but the misstatements are not pervasive. An adverse opinion is issued when the misstatements are material and pervasive. A disclaimer of opinion report is issued when the auditor cannot gather sufficient evidence upon which to form an opinion and the effects of any undetected misstatements are potentially material and pervasive.

Audit reports are more complicated in the case of state and local governments, where there is often more than one ***opinion unit***, defined as a level at which an opinion is formed. In state and local governments, separate opinion units include governmental activities, business-type activities, the aggregate of discretely presented component units, each major fund, and the aggregate of all nonmajor funds (including the internal service fund and fiduciary funds which are not identified as major or nonmajor).[16]

To be able to issue an audit report at disaggregated levels (not just at the reporting entity level) requires that ***materiality*** be determined for each opinion unit. A materiality amount is established in the audit planning stage and is meant to signify the point at which the magnitude of a given error would affect a financial statement user's perception of the financial condition or results of the audited entity. The requirement for the auditor to quantify these disaggregated levels (that is, opinion units) adds a layer of complexity to GAGAS audits of state or local government entities. Furthermore, government entities may choose to have a higher level of disaggregation, for example, having every fund whether major or not treated as a separate opinion unit. Having more opinion units increases the scope of the audit, and consequently the cost.

The audit report, whether for a government or nonprofit entity, is required to have certain elements (AU-C 700A):

- A title with the word "independent";
- The addressee;
- An introductory paragraph;
- A section titled "Management's Responsibility for the Financial Statements";
- A section titled "Auditor's Responsibility";
- A section titled "Opinion";
- If applicable, a section titled "Report on Other Legal and Regulatory Requirements";
- Signature of the auditor; and
- Date of the auditor's report

If applicable, the report will also include a paragraph for "Other Matter(s)," consistent with AICPA Codification AU-C Section 706, which addresses emphases of matters. The audit report for the City of Dixon, Illinois, is provided below as an example of a report with an unmodified opinion for the fiscal year (seven years after the detection of the fraud discussed earlier):

[16] For special-purpose governments engaging in only business-type activities and with no component units, there will be only one opinion unit.

WIPFLi LLP
CPAs and Consultants

Wipfli LLP
215 East First St-Suite 200
Dixon, IL 61021

615.315.0854
Fax 615.268.0584

www.wipfli.com

Independent Auditors' Report

Honorable Mayor and Commissioners
City of Dixon, Illinois
Dixon, Illinois

We have audited the accompanying financial statements of the governmental activities, the business type activities, each major fund, and the aggregate remaining fund information of the City of Dixon, Illinois as of and for the year ended April 30, 2019, and the related notes to the financial statements, which collectively comprise the City of Dixon, Illinois' basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the City of Dixon, Illinois as of April 30, 2019, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States.

The City of Dixon received an unmodified opinion on its fiscal year end April 30, 2019, financial statements.

Emphasis of Matter

As discussed in Note 1 to the financial statements, the City adopted new accounting guidance GASS Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, during the year ended April 30, 2019. Our opinions are not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the schedule of funding progress, schedule of change in employer's net pension liability and related ratios, schedule of employer contributions and budgetary comparison information on pages 63 – 74 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Required supplementary information is not audited although auditors apply certain limited procedures on the information.

Management has omitted the management's discussion and analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

A government may not include Management's Discussion and Analysis, which is a part of required supplementary information, and still receive an unmodified opinion.

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Dixon, Illinois' financial statements as a whole. The combining non major fund statements listed in the table of contents on pages 75 – 80 are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The combining nonmajor funds, private purpose trust fund, pension trust fund, and agency fund statements are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the combining nonmajor funds, private purpose trust fund, pension trust fund, and agency fund statements are fairly stated, in all material respects, in relation to financial statements taken as a whole.

The Schedule of Assessed Valuations, Rates, Extensions and Collections listed in the table of contents has not been subjected to the auditing procedures applied in the audit of the basic financial statements and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by *Governmental Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated October 21, 2019, on our consideration of the City of Dixon, Illinois' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the City of Dixon, Illinois' internal control over financial reporting and compliance.

Wipfli LLP

Dixon, Illinois
October 21, 2019

3

Review 16-2 LO2

GAGAS standards have evolved to become more explicit about certain ethical audit attributes. One of the more significant relates to independence and specifically whether auditors should prepare their client's financial statements.

Required:
Why is the preparation of financial statements by the auditor a potential threat to independence? What safeguards are required to ensure auditor independence when the auditor prepares client financial statements?

Solution on p. 16-34.

Other Types of Assurance and Attestation Engagements for Government and Nonprofit Entities

Government and nonprofit entities may have need for other audits or attestation engagements other than a financial statement audit. Although the financial statement audit is generally responsive to requirements placed on the government or nonprofit entity by funding agencies (e.g., federal or state governments or foundations), CPA firms or government audit agencies may also provide engagements that focus on a specific need outside of financial statement assurance.

eLectures MBC **LO3** Classify other types of assurance and attestation engagements applicable to government and nonprofit entities.

Performance Audits

The 2018 Yellow Book, Chapters 8 and 9, provides standards fieldwork and related reporting associated with performance audits. Also referred to as "operational" or "efficiency" audits, the goal of a performance audit is to provide information to the client to assist in reducing costs, increasing efficiency, improving operations, and/or increasing effectiveness. These objectives may be applicable to both government and nonprofit entities. Although either a government or nonprofit entity could have a performance audit, these audits are more common for government entities. Many of the standards applicable to financial statement audits are also applicable to performance audits. However, performance audits evaluate programs or activities, which vary significantly, causing each performance audit to be unique. The standards for conducting performance audits therefore require that auditors gain an understanding of the nature of the program or activity being evaluated. The 2018 Yellow Book identifies six program attributes that should be considered: (1) visibility and other risks of the program, (2) age of the program, (3) size of the program, (4) other reviews or oversight of the program, (5) the strategic plan and objectives of the program, and (6) related external forces.

Performance audits require auditors to develop criteria against which to assess the client's performance and may require consideration of internal controls. Similar to financial statement audits, performance audits involve the evaluation of evidence, development of findings, documentation of findings, and communication of findings. The 2018 Yellow Book provides application guidance for report distribution and reporting of confidential or sensitive information.

Performance audits may be performed by CPA firms or government agencies. The GAO conducts many performance audits in its role in the legislative branch of the U.S. federal government. Often referred to as the "congressional watchdog," GAO often presents its findings and recommendations before Congress. In light of its documented concern with the federal government's fiscal condition and projected future condition, the GAO has identified potential cost savings in 23 programs including the Department of Defense, the Department of Energy, the Department of Veterans Affairs, and the Coast Guard, among others. These potential savings are described in the GAO's 2018 Annual Report: *Additional Opportunities to Reduce Fragmentation, Overlap, and Duplication and Achieve Other Financial Benefits*.

Attestation Engagements

Chapter 7 of the 2018 Yellow Book addresses the standards for attestation engagements, defined to include *examination* engagements, *review* engagements, and *agreed-upon-procedures* engagements. Distinct from audits (either financial statement or performance), these attestation engagements may be appropriate when the assurance of a financial statement or performance audit is not necessary. Specifically, an attestation engagement provides a lower level of assurance than an audit. These attestation engagements may include an examination engagement (high-level assurance), a review engagement (limited assurance), or an agreed-upon procedures engagement (report issued, but no opinion), presented in decreasing order of assurance. For these engagements, 2018 Yellow Book, Chapter 7, Standards for Attestation Engagements and Reviews of Financial Statements, extends the AICPA's Statements on Standards for Attestation Engagements (SSAEs).

These lower-assurance engagements are common for smaller government entities where a financial statement audit is not required. These engagements are less costly, and yet provide some insight, although with less assurance than an audit. As an example, the Auditor of State in Ohio has routinely applied agreed-upon procedures to its smaller units of governments. These engagements review internal controls and certain, more significant transactions. The reports issued for these engagements clearly identify the tests performed. The excerpt below is the first paragraph from the report on agreed-upon procedures for the Village of South Point, Ohio, for the fiscal years ended December 31, 2015 and 2014, conducted by the Auditor of State of Ohio. Following this opening paragraph, the report describes specific testing related to cash; property taxes and intergovernmental receipts; water, sewer, and sanitation funds' charges for services; debt; payroll cash disbursements; non-payroll cash disbursements; mayor's court transactions and cash balances; compliance—budgetary; compliance—contracts and expenditures; and other compliance.

INDEPENDENT ACCOUNTANTS' REPORT

THE SEAL OF THE AUDITOR OF STATE OF OHIO

Dave Yost • Auditor of State

INDEPENDENT ACCOUNTANTS' REPORT ON APPLYING AGREED-UPON PROCEDURES

Village of South Point
Lawrence County
415 Solida Road
South Point, Ohio 45680

We have performed the procedures enumerated below, with which the Village Council and Mayor, and the management of the Village of South Point, Lawrence County, Ohio (the Village) have agreed, solely to assist the Council and Mayor in evaluating receipts, disbursements and balances recorded in their cash-basis accounting records for the years ended December 31, 2015 and 2014, including mayor's court receipts, disbursements and balances, and certain compliance requirements related to these transactions and balances. Management is responsible for recording transactions; and management, the Mayor, and/or the Council are responsible for complying with the compliance requirements. This agreed-upon procedures engagement was conducted in accordance with the American Institute of Certified Public Accountants' attestation standards and applicable attestation engagement standards included in the Comptroller General of the United States' *Government Auditing Standards*. The sufficiency of the procedures is solely the responsibility of the parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Review 16-3 LO3

GuidedExamples MBC

The U.S. Government Accountability Office (GAO) conducts many performance audits related to federal government programs and agencies. The Medicare program (which provides health coverage for the elderly and disabled) and the Medicaid program (which provides health insurance for lower income individuals) are important to the health of many Americans. In March 2019, the GAO issued a report based on a performance audit of these programs, titled "Medicare and Medicaid: CMS Should Assess Documentation Necessary to Identify Improper Payments." In this report, the GAO made recommendations to the Centers for Medicare and Medicaid Services (CMS) based on their audit.

Required:

Access the GAO report at https://www.gao.gov/assets/700/697981.pdf. For the six program attributes identified above that GAGAS states should be considered in a performance audit, describe evidence in the report of the GAO's consideration. In addition, discuss the four primary recommendations presented by GAO in their report and whether CMS agreed with the recommendations.

Solution on p. 16-35.

Uniform Guidance Audits (Commonly Referred to as Single Audits)

Purpose of the Uniform Guidance Audit

eLectures MBC **LO4** Understand the purpose of and developments associated with the Single Audit Act of 1984 and Uniform Guidance.

So far, the scope of the financial statement audits we have explored has been limited to GAAS audits and GAGAS audits. Although these are the only two sets of standards by which government or nonprofit audits may be conducted, we must also consider one more variation of the GAGAS financial statement audit. When government or nonprofit entities receive and expend federal grant awards (note the distinction between grant revenues and program service, or fee-for-service, revenues described earlier this chapter), the scope of the audit may be expanded. Currently, when government or nonprofit entities expend $750,000 or more of federal grant awards, a "Uniform Guidance" audit is required. Uniform Guidance refers to 2 CFR (Code of Federal Regulations) 200—Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards.

The rationale for this expanded scope audit is the nature and magnitude of the federal tax dollars that have been entrusted with government and nonprofit entities through grant awards for the purpose of advancing some national objective. The U.S. Office of Management and Budget (OMB) estimates that federal grants to state and local governments in 2019 totaled approximately $750 billion. These grants and those to nonprofit organizations are designed to meet national objectives including health care, education, social services, housing, infrastructure, transportation, and safety.[17] These awards are provided through various federal agencies such as the U.S. Department of Health and Human Services, the U.S. Department of Education, the U.S. Department of Agriculture, the U.S. Department of Housing and Urban Development, the U.S. Department of Transportation, and the U.S. Department of Justice, among others. Grant awards vary in scope and requirements, with some providing more discretion in the spending of the award by the grantee.

The government or nonprofit auditee is assigned one federal cognizant or oversight agency, regardless of the number of federal grant funding agencies, to streamline the audit process.[18] In all cases, however, oversight is necessary to ensure accountability, and the Uniform Guidance audit is a primary accountability tool.

In addition to the reports required by the 2018 Yellow Book, a Uniform Guidance audit includes controls and compliance testing specifically for some grant awards, with reports and opinions often required at the program (rather than entity level). These audits also require transparency—the results of the audits are submitted to the Federal Audit Clearinghouse, a repository of Uniform Guidance information managed by the U.S. Census Bureau. The substantial audit requirements, combined with the transparency of the audit results, create an accountability framework for federal grant awards.

Key Developments of the Uniform Guidance Audit

The Uniform Guidance audit is the culmination of more than 30 years of legislative and administrative developments designed to ensure and promote accountability with federal grant awards. The U.S. Congress passed the Single Audit Act in 1984 to rectify piecemeal audits that were previously conducted for one federal grant awardee/auditee by multiple federal agencies, which signifies the purpose of the term "single audit." The legislation sought to provide greater accountability with grant awards and a more efficient audit process, and it initially applied to state and local governments that received more than $100,000 in federal grant awards.

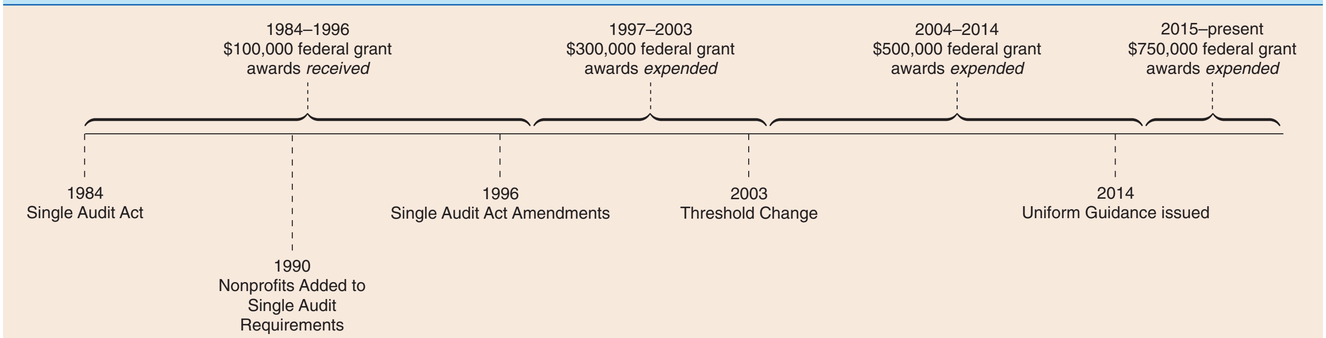
After the initial legislation, four key dates and guidelines are associated with the development of the single audit, as depicted in **Figure 16-3**. First, in 1990, the U.S. Office of Management and Budget (OMB) issued OMB Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," extending requirements to nonprofit organizations receiving more than $100,000 in federal grant awards. Second, in 1996, U.S. Congress passed amendments changing the threshold from

[17] U.S. Office of Management and Budget. *Budget of the United States Government*, *Fiscal Year 2020: Historical Tables*, Table 12.1, Summary Comparison of Total Outlays for Grants to State and Local Governments: 1940–2024.

[18] The federal cognizant or oversight agency may vary for local governments, but the U.S. Department of Health and Human Services (DHHS) is assigned to oversee these audits for state governments due to the significance of their funding to the states.

$100,000 to $300,000, changing the measurement basis from federal grants ***received*** to ***expended***,[19] and adding a risk-based focus to these audits. Third, effective beginning in 2004, the OMB increased the threshold from $300,000 to $500,000. Fourth, and finally, the OMB issued *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (generally called Uniform Guidance) effective for fiscal years beginning after December 26, 2014. The two most significant elements of Uniform Guidance include: (1) increasing the threshold for having a Uniform Guidance audit from $500,000 to $750,000 of federal awards expended, and (2) accumulating a number of OMB circulars into one comprehensive document.[20,21]

FIGURE 16-3 **Timeline of the Single Audit/Uniform Guidance**



The terminology associated with Uniform Guidance audits can be especially challenging to those not familiar with the guidance. Although OMB Circular A-133 was subsumed in the Uniform Guidance, some auditors in practice may still refer to these audits as "A-133 audits," referring to the OMB circular in place from 1990 through 2014. However, the most appropriate term is a "Uniform Guidance audit," with the term "single audit" still appropriate given the history and the use of the term within Uniform Guidance. You should know that all three terms generally refer to the same types of audit.

Requirements of a Uniform Guidance Audit

A full-scope Uniform Guidance audit is generally required for nonfederal (state or local government or nonprofit) organizations "expending" more than $750,000 of federal grant awards in a fiscal year. However, if all the grant revenues come from a single federal program, an auditee may, in some circumstances, elect a program-specific audit. Although most of the report requirements are the same, the program-specific audit is somewhat narrower in focus, and likely less expensive.

A Uniform Guidance audit includes all the testing and reports required by GAGAS. It also includes additional testing of controls and compliance for each program that meets the definition of a *major program*. Uniform Guidance defines a "major program" as a federal program (that is, funding from a federal agency and program to a state or local government or nonprofit organization) that meets certain risk and size criteria. Note that the term "program" refers to the *entire* federal program, not to the "awards" that a government or nonprofit entity receives. Classification of a federal program as "major" relies on both prescriptive criteria and auditor judgment.

First, the auditor must determine which of the federal programs in which their client participates are "Type A" programs. The *Catalog of Federal Domestic Assistance* (CFDA)[22] catalogs all of the

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[19] Currently (and similar to past definitions), Uniform Guidance defines expenditures as "charges made by a non-Federal entity to a project or program for which a Federal award was received (2 CFR 200.34)." The shift from ***received*** to ***expended*** results in smoother amounts year-to-year and more properly aligns compliance requirements and related audit testing with the time over which grant awards are expended.

[20] Uniform Guidance may be found in Title 2 of the Code of Federal Regulations Part 200 (i.e., 2 CFR 200). Uniform Guidance subsumed eight OMB circulars, establishing all of the guidance for these audits as well as the principles for allocating costs to federal grants in one authoritative document. Uniform Guidance audits were effective for entities with fiscal years beginning after December 26, 2014, i.e., essentially for fiscal years ending December 31, 2015, and later.

[21] For a more thorough discussion of the history leading up to the implementation of Uniform Guidance, see "A Historical Evaluation of the Single Audit: Thirty Years from Initial Legislation to Uniform Guidance," by Kerri L. Tassin, Tammy R. Waymire, and Christopher S. Hines, *Journal of Governmental and Nonprofit Accounting*, Vol. 8, No. 1, pp. 21–35.

[22] The CFDA is available online at **beta.sam.gov**.

assistance programs offered by various U.S. government agencies. Generally, all CFDA programs are assigned a number that identifies both the federal funding agency (first two numbers) and the federal program (last three numbers). All grants with the same program number are combined as a single program even if they are reported separately in the government's or nonprofits financial statements. A grant or federal program is classified as Type A based on the following criteria:

Total Federal Awards Expended	Threshold for Type A Programs
Equal to or exceed $750,000 but less than or equal to $25 million	$750,000
Exceed $25 million but less than or equal to $100 million	Total federal awards expended times 0.03
Exceed $100 million but less than or equal to $1 billion	$3 million
Exceed $1 billion but less than or equal to $10 billion	Total federal awards expended times 0.003
Exceed $10 billion but less than or equal to $20 billion	$30 million
Exceed $20 billion	Total federal awards expended times 0.0015

Any programs not determined to be Type A are classified as Type B. For the programs classified as Type A, the auditor must assess whether the program is low risk by applying these four criteria:

(1) The program must have been classified as a major program in one of the last two years,

(2) The client (government or nonprofit) must not have had material weaknesses reported in connection with its major programs in the previous year,

(3) The client must not have had a modified opinion in the auditor's report on major programs in the previous year, and

(4) The client must not have had known or likely questioned costs exceeding 5% of total federal awards in the previous year.

For the programs classified as Type B and that meet certain size criteria, the auditor must determine whether those programs are high-risk based on their professional judgment and by applying certain Uniform Guidance criteria. The auditor must consider current and prior audit experience, oversight by federal agencies, and inherent risk of the program.

Using the classification as Type A/Type B and risk evaluations, the auditor determines which programs are major—all Type A programs that do not meet the low-risk criteria are classified as major. All Type B programs identified as high risk must also be classified as major. In addition, the auditor also must include enough other federal programs as major, so that the amount the auditor determines are its client's major programs equal a minimum of 40% of total federal grant *awards* their client expended during the year. Reference here is to "awards," not *programs*—the amount of federal money that the auditor's client actually expended—used or spent.

The mechanics of all this is hard to imagine without seeing an example that illustrates how the criteria are applied! For fiscal year ended December 31, 2017, the Boys and Girls Clubs of America, a nonprofit organization located in Atlanta, Georgia, expended $27,258,277 of federal grant awards and was therefore subject to a Uniform Guidance audit. The table below summarizes the Club's federal awards:

CFDA (Catalog of Federal Domestic Assistance) Numbers, Agencies, and Descriptions				Expenditures and Findings		
Agency Prefix	CFDA Extension	Agency Name	Name of Federal Award	Amount Expended	Major Program	Type of Audit Report on Major Program
16	726	U.S. Department of Justice	Juvenile Mentoring Program	$25,483,691	Yes	U
93	858	U.S. Department of Health & Human Services	National Collaboration to Support Health, Wellness	360,651	Yes	U
10	558	U.S. Department of Agriculture	Child and Adult Care Food Program	954,008	Yes	Q
43	008	National Aeronautics & Space Administration	Education	110,291	No	N/A
16	808	U.S. Department of Justice	Recovery Act—Edward Byrne Memorial Competitive	(1,177)	No	N/A
16	731	U.S. Department of Justice	Tribal Youth Program	1,179	No	N/A
15	931	U.S. Department of Interior	Conservation Activities by Youth Service Organizations	64,033	No	N/A
10	559	U.S. Department of Agriculture	Summer Food Service Program for Children	285,601	No	N/A
				$27,258,277		

Source: U.S. Federal Audit Clearinghouse

Note that the Catalog of Federal Domestic Assistance (CFDA) provides a unique number to each federal funding agency and each federal program within each agency. For example, the Boys and Girls Clubs of America expended most of its federal grant awards ($25,483,691 of their $27,258,277 total, or approximately 93%) via CFDA Program 16.726, where 16 indicates the award was provided by the U.S. Department of Justice, and 726 indicates that the program is the Juvenile Mentoring Program (JUMP). Each CFDA program number is associated with unique compliance requirements. The stated objective of this program is to "improve outcomes for at-risk and high-risk youth, and reduce negative outcomes (including juvenile delinquency, substance use, and gang participation) through the provision of mentoring services." Compliance Supplements are published each year by the U.S. federal government that describe the compliance requirements for each program, providing auditors with the information they need to test whether requirements have been met. In the JUMP example, compliance requirements might include testing of documentation to ensure that mentoring services were provided that meet grant criteria.

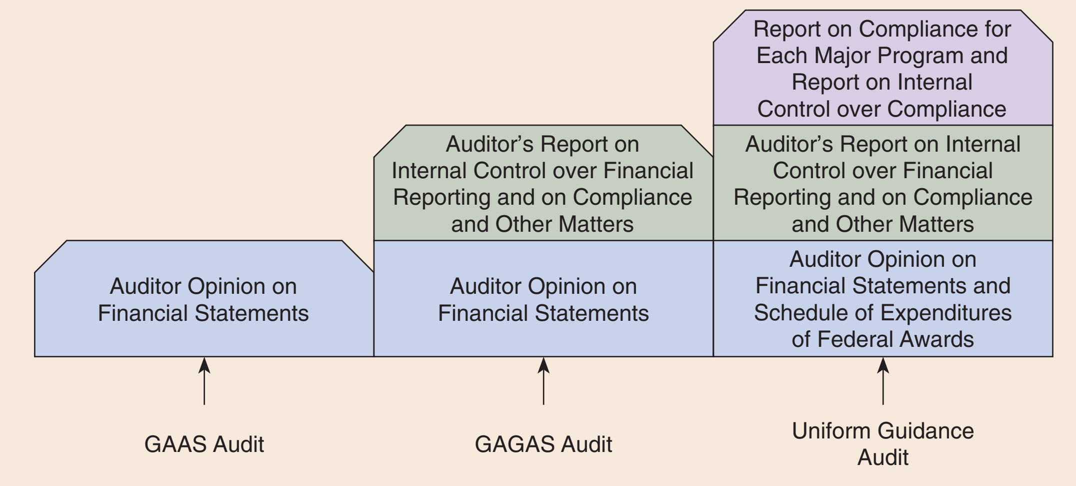
This JUMP program, as well as CFDA Program 93.858, National Collaboration to Support Health, Wellness provided by the U.S. Department of Health & Human Services, and 10.558, Child and Adult Care Food Program provided by the U.S. Department of Agriculture, are all considered to be major programs under the prescriptive and professional judgment criteria described above. With total federal awards of $27,258,277, programs expending federal grant awards in excess of $817,748 (or 3%) total federal grant awards expended are considered Type A programs, and both the JUMP Program and the Child and Adult Care Food Program exceed this threshold, and the National Collaboration to Support Health and Wellness Program is below this threshold (making it Type B). All Type A programs not meeting low-risk criteria are considered to be major, and high-risk Type B programs are also considered major, where the number of programs treated as major must collectively represent a minimum of 40% of federal grant awards in total. As noted, the JUMP program alone represents approximately 93%, which suggests that the Child and Adult Food Care Program must not have met low-risk criteria and the National Collaboration to Support Health and Wellness Program must have been determined to be high risk.

Note in the previous chart that, for those three programs identified as major, the type of audit report on each major program is indicated. For these major programs, the auditor is required to gain an understanding of the internal controls and also to test compliance with the awards. Compliance requirements might include testing to make sure beneficiaries (i.e., students participating in Boys and Girls Clubs programs) meet grant eligibility criteria or other requirements established by the funding agency. A Uniform Guidance audit requires auditors to express an opinion on the financial statements and on the required Schedule of Expenditures of Federal Awards (the contents of which look similar to the table above with CFDA number with amounts expended). In addition, consistent with GAGAS, a report is issued on internal control over financial reporting and on compliance and other matters. The reference to the audit report on a major program above, however, refers to a specific Uniform Guidance requirement for a Report on Compliance for Each Major Program. For the Juvenile Mentoring Program and the National Collaboration to Support Health, Wellness, the "U" refers to the opinion being unmodified, i.e., clean. For the Child and Adult Care Food Program, the "Q" refers to the opinion being qualified.

Uniform Guidance Audits and Federal Audit Clearinghouse (FAC) Submissions

As we learned in the previous section, the primary distinction for a Uniform Guidance audit is the testing of major programs. Once the auditors identify which of their client's programs are major, they conduct the work necessary to issue an opinion on compliance with major programs and to consider internal controls over those programs. These reports extend the other GAGAS reports which include: (1) an audit report on the financial statements, and (2) a report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements. When a Uniform Guidance audit is required, the opinion on the financial statements is extended to cover the schedule of expenditures of federal grant awards (SEFA). **Figure 16-4** depicts the information that is available from an audit conducted in accordance with GAAS, an audit that is conducted in accordance with GAGAS, and a GAGAS audit that meets Uniform Guidance audit criteria.

FIGURE 16-4 ■ **Elements of GAAS, GAGAS, and Uniform Guidance Audits**



As noted at the outset of this learning objective, the Uniform Guidance also induces transparency, as the results of the audit must all be submitted to the Federal Audit Clearinghouse (FAC). Managed by the U.S. Census Bureau, the FAC provides information about Uniform Guidance audit filings to the public, available via individual organization search or via download of all filings in one database. The information that is available from FAC is obtained from the SF-SAC reporting form, which is generally completed by the auditor and then submitted electronically to the FAC.

The complete FAC reporting package includes the following auditor-completed items (2 CFR §200.515):

1. Auditor opinion (or disclaimer of opinion) on the financial statements and the schedule of expenditures of federal awards
2. A report on internal control over financial reporting and compliance with laws, regulations, and grant awards
3. A report on compliance for each major program (opinion issued) and report on internal control over compliance
4. A schedule of findings and questioned costs, including:
   a. Summary of auditor's reports, including the following information:
      i. Type of opinion issued on the financial statements
      ii. Whether significant deficiencies or material weaknesses were noted in the audit of the financial statements
      iii. Whether any noncompliance was noted that is material to the financial statements
      iv. Whether significant deficiencies or material weaknesses were noted in internal control over major programs
      v. Type of opinion issued on major program compliance
      vi. Whether any audit findings (internal control deficiencies, material noncompliance, known questioned costs above $25,000, known or likely fraud, or misrepresentation of prior audit findings) were noted related to a major program and that are required to be disclosed
      vii. Identification of all major programs
      viii. Threshold used to identify Type A programs
      ix. Whether the auditee was determined to be low risk
   b. Findings relating to the financial statements
   c. Findings and questioned costs for federal awards

Uniform Guidance Audit Findings

In our previous example of the Boys and Girls Clubs of America for the fiscal year ended December 31, 2017, the auditor issued a modified (qualified) audit opinion on major program compliance for the Child and Adult Care Food Program. In addition, the Schedule of Findings and Questioned Costs stated that there was an audit finding required to be reported under 2 CFR §200.516(a), described in #4(a)(vi) above. This Schedule provides detail of the finding related to the Child and Adult Care Food Program, noting that the grant requires periodic evaluation and on-site monitoring of facilities where meals are served, as well as documentation of the evaluation. The auditor noted the absence of such documentation, assessed the cause and effect of the condition noted, and recommended changes in procedures to ensure the grant-required monitoring.

In addition to the auditor report information above, the grantee/auditee must also prepare a summary schedule of prior audit findings. This reporting helps federal granting agencies to determine whether grantees have closed the loop by acting on previous auditor findings. In the summary schedule of prior audit findings, the auditee notes that one of the following has happened: (1) previous findings were corrected, (2) previous findings were partially corrected or not corrected and the reasons full correction was not taken, or (3) findings were not addressed because the auditee believe action is unnecessary. The auditee is also required to prepare a corrective action plan related to current period findings that addresses the corrective actions that will be taken. This iterative approach is designed to ensure corrective action is taken on deficiencies noted in the audit.

Uniform Guidance Audit Quality

You can certainly surmise the complexity of Uniform Guidance audits based on our discussion above. It may not be surprising, therefore, to expect the quality of these audits to be jeopardized if auditors are not well trained in Uniform Guidance. In the three years preceding the discovery of the fraud in the City of Dixon, Illinois, the City was subject to the single audit (now, Uniform Guidance) and its audit was completed by a small local audit firm that employed just two CPAs and only had one municipal client, the City of Dixon.[23] GAGAS state, "Ethical principles apply in preserving auditor independence, taking on only work that the audit organization is competent to perform, performing high-quality work, and following the applicable standards cited in the audit report." When firms conduct fewer government audits, research indicates that the audit produces fewer findings (that deficiencies may go undetected); a low level of expertise is therefore one indication of lack of competence.[24] Despite the caution to only take on audit work that a firm is competent to perform, this research reveals approximately 30% of single audits over the period from 2004 to 2010 were performed by audit firms only performing 10 or fewer such audits in a given year and 25% of all Uniform Guidance audits in 2017 were performed by firms conducting fewer than 10 such audits that year.[25] Although an audit firm can gain the knowledge necessary to be competent in conducting government audits, the lower levels of expertise present an audit quality concern.

The U.S. federal government has long noted concerns with quality among single audits. The President's Council on Integrity and Efficiency (PCIE 2007) conducted a National Sampling Project using 208 single audits for fiscal years ending in 2003 and 2004, estimating that 35.5% to be unacceptable and another 16.0% to be of limited reliability. The quality of the audits was noted to be more significantly impaired among the smaller auditees. In cases where audits were deemed unacceptable, audit documentation for testing of internal controls and compliance was missing, deficiencies were present that the auditor missed, and/or there were reporting and presentation errors.[26]

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[23] Prior to 2009, the City of Dixon audit had been conducted by a large national firm for many years during which the fraud was determined to have occurred. Of the $36 million in judgments against the two audit firms, $35 million was paid by the large national firm and $1 million was paid by the local firm described above.

[24] Waymire, Webb, and West (2018) published the article, "A Comprehensive Analysis of Findings from Single Audits: The Implications of Auditee Type and Auditor Expertise," in the *Journal of Governmental and Nonprofit Accounting*, and the study covered the period from 2004 to 2010, using data from 24,144 single audit. Waymire, Webb, and West (2019) published another article, "To Audit or Not to Audit: Whether to Accept a Uniform Guidance Audit," in *CPA Journal*, and the article used data from more than 28,000 Uniform Guidance audits from 2017. In both studies, lack of expertise in government audits was associated with fewer compliance findings from the audit.

[25] Ibid.

[26] See "Report on National Single Audit Sampling Project" published by the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency published in 2007.

The AICPA has taken steps to address Uniform Guidance audit quality. It created the Government Audit Quality Center (GAQC) in 2004, and the GAQC provides resources to those conducting government audits, including CPA firms and state audit organizations. The AICPA has studied the impact of membership in the GAQC on single audit quality in the pre-Uniform Guidance period. In a sample of 87 such audits, the study noted that GAQC membership and expertise of the firm in this audit area are associated with better audit quality.[27]

The major take-away points for those studying governmental auditing are: (1) the quality of Uniform Guidance audits is a serious concern, and (2) only those audit firms and other audit organizations possessing adequate expertise specific to these audits should take on such an engagement. It may be tempting for firms to consider bidding on a government audit, particularly when the timing of the audit does not coincide with most firms' busy season. However, when firms conduct very few of these audits, it is challenging for them to gain the skills to conduct a quality audit. For states that do not have a state audit agency which can perform these audits, the quality of Uniform Guidance also depends upon the availability and willingness of firms with the needed expertise to agree to conduct them.

LO4 **Review 16-4**

GuidedExamples MBC

The table of the federal grants awards expended by the Boys and Girls Clubs of America (presented earlier in the chapter) reflected the vast majority of federal funding being provided by the U.S. Department of Justice (DOJ). Other examples of federal agencies include the U.S. Department of Health and Human Services (DHHS) and the U.S. Department of Agriculture (USDA).

Required:
Would you have expected the vast majority of this organization's federal funding to come from DOJ? If not, what federal agency would you have expected to provide the most funding for this organization? Reflect on the funding from the table on page 16-20 and explain a likely reason for the DOJ to be the primary source of federal funds for this organization.

Solution on p. 16-35.

Special Topics Applied to Government and Nonprofit Auditing

eLectures MBC **LO5** Explore special topics as they relate to audits of government and nonprofit entities.

Thus far, this chapter has focused primarily on topics applicable to audits of government and nonprofit entities, including Generally Accepted Government Auditing Standards (GAGAS) and Uniform Guidance audits (also referred to as single audits). Just as these standards and requirements have some common building blocks with the AICPA auditing standards for for-profit entities, other broad audit issues translate into the government and nonprofit audit setting and warrant exploration. One such topic is the rational decision-making model which has garnered significant attention in the audit industry because of its implications for objectivity, professional skepticism, and judgment. A separate, second such topic is the use of special-purpose frameworks as alternatives to generally accepted accounting principles (GAAP). Fairly common in the government setting, special-purpose frameworks warrant adjustments in the audit approach and the audit reports issued. In this section, we will explore both topics.

Rational Decision-Making and Cognitive Biases

The value of audits is dependent upon achieving the tenets of objectivity, professional skepticism, and sound judgment. In recent years, the audit industry has taken note of decades of cognitive psychology research which suggests that human decision-making is not as rational as perhaps we would like to think it is. In his book *Thinking Fast and Slow*, Nobel Prize-winning economist Daniel Kahneman describes multiple studies that he and his co-author Amos Tversky conducted which categorize decision-making into one of two systems—System 1, which is reflexive, fast, and instinctive, and System 2, which is deliberative, slower, but generally more precise. In applying these two systems of thinking, researchers have also identified what they describe as cognitive decision-making biases which threaten

[27] See AICPA GAQC Alert #340 from August 3, 2017, which reports the results of this study.

rational decision-making. These biases are different from those prohibited by the 2018 Yellow Book. While Yellow Book standards on independence, ethics, and professional judgment require auditors to be nonpartisan in evaluating government programs, cognitive decision-making biases are not conscious decisions. Rather they are human tendencies which threaten judgment in all decisions, not just those in which the auditor may have pre-existing views about a particular program being administered by a government or nonprofit entity.

Many of the more than 100 such biases have applicability to the audit setting and have resulted in firms taking steps to mitigate the effect of these unconscious biases. KPMG, for example, published a monograph in 2011 titled "Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework." In it, four specific cognitive biases are described and steps for mitigating those biases are also described. Similarly, other firms including other Big 4 as well as other national, regional, and local firms are incorporating training and processes to ameliorate cognitive bias in auditing.

The four biases discussed in the KPMG monograph include (not in their original order): (1) overconfidence, (2) availability, (3) confirmation, and (4) anchoring. Although only a fraction of the cognitive biases that affect decision-making may have implications in the audit setting, discussion of these four biases should provide a sense of the risks of biases and help in identifying situations in which the bias may be prevalent. Moreover, all readers should be able to readily identify examples, in their own decision-making or that of others, of each of the four biases.

The overconfidence bias is the tendency of individuals to approach a task or an assignment with more confidence than they should have in their own abilities. We see this bias in every-day decision-making, as one of the most commonly cited examples of overconfidence is the statistic that more than 90% of drivers believe that they are above average in their driving ability. Similarly, professionals may also be overconfident in their abilities or those of their colleagues. Auditors at staff and supervisory levels would be well served to be fully aware of what they know, and of what they do not know. The KPMG monograph cites the following undesirable outcomes possible with overconfidence: "neglecting to ask for needed help or guidance, failing to acquire needed knowledge, poor task performance, budget overruns, assignment of audit tasks to underqualified subordinates, and under-review of subordinates' working papers." Specific to audits of government and nonprofit entities, recall that GAGAS require that auditors be competent to perform the audit; this bias suggests additional caution should be exercised in accepting and conducting a GAGAS audit. Broadly, the overconfidence bias is also noted to facilitate other biases.

The availability bias is the tendency of individuals to use information that is readily accessible in making decisions. Not necessarily detrimental on its face, the availability bias, however, may mean that individuals choose to incorporate this information even if it is not as relevant in their decision. For example, one study reported that individuals believed that tornadoes were more deadly than asthma, although the latter are associated with 20 times more deaths. It is the salience, or vivid depiction, of some events that causes us to weight them more heavily. The KPMG monograph notes that the availability bias may affect the choice of audit procedures to the detriment of audit quality. Specific to government and nonprofit auditing, the possibility of publicity and/or news related to their clients creates salient information that may be difficult for auditors to properly weight.

The confirmation bias is the tendency of individuals to seek out evidence that confirms what they already believe. We tend to form assessments of our environments quickly (System 1 thinking, described above), and this bias suggests that it is challenging to change our initial assessments. Research has provided evidence of the prevalence of the confirmation bias, also referred to as the confirmation trap, in many professions. In the auditing setting, whether of for-profit, nonprofit, or government entities, the risk is that judgments will be biased in favor of the auditor's initial assessment, whether accurate or not. The KPMG provides links to audio vignettes that depict framing by a client CFO, framing which may result in an auditor's overreliance on management explanations. The confirmation bias is also squarely at odds with professional skepticism, defined earlier in the chapter, which requires maintaining an inquisitive nature and a commitment to seeking out facts.

Anchoring bias is the tendency of individuals to form estimates by starting with a numerical value, an anchor, but failing to adjust sufficiently. Everyday examples of anchoring can be observed in the purchase of homes (do buyers adjust sufficiently from list prices?) and in the purchase of automobiles (do buyers adjust sufficiently from sticker prices?). In auditing, anchoring poses risks in the testing of every account balance; management provides a starting trial balance, and the auditor tests each balance, but is already anchored to the amount provided. Specific to Yellow Book and Uniform Guidance audits, compliance testing is subject to the threat of anchoring bias also. In testing the allocation of costs to a specific grant, the auditor works from client-asserted information, posing anchoring risks.

These four biases—overconfidence, availability, confirmation, and anchoring—are fairly intuitive. In learning about these biases, readers likely identified examples of each in their own decisions or in the decisions of others. Applied to the audit setting, these biases threaten audit quality, by posing risks to objectivity, professional skepticism, and sound judgment. Given the concerns noted in the audits of government and nonprofit audits in the previous learning objective, these four biases, as well as others not covered, pose additional threats to audit quality.

The question then is what remedies may be pursued to mitigate these biases. In his book *Thinking Fast and Slow*, Daniel Kahneman describes these biases as pervasive and persistent; i.e., we are not likely to eliminate decision-making bias. However, there are some remedies which may serve to mitigate bias. First, education is key. Knowing the biases exist is a good first step; auditors should participate in ongoing training opportunities to learn to identify and reduce biases in judgment. In addition, the KPMG makes the following three recommendations: (1) be intentional in making the case against what you think you will find in an audit, (2) enlist the expert opinions of others without framing their decision for them, and (3) incorporate the use of data including formal probabilities.

Special-Purpose Frameworks and the Conducting of an Audit

The assumption to date in this chapter has been that government and nonprofit clients follow generally accepted accounting principles (GAAP) in the preparation of their financial statements. However, as is the case for for-profit entities, governments and nonprofits may elect, in some cases, to prepare their financial statements using some other framework other than the reporting model established by the FASB (nonprofits) or the GASB (state and local governments). Referred to as special-purpose frameworks, these alternative bases of accounting may be selected by the reporting entity, by a regulatory body, or by a funding agency. The election of a non-GAAP basis of accounting will require adjustments to the audit approach and report as well.

The use of special-purpose frameworks is likely more common among state and local governments, as each state legislature establishes whether GAAP is required for each type of government. The National Association of State Auditors, Comptrollers and Treasurers (NASACT) conducts an annual survey of the 50 states to determine whether GAAP is required. At least 16 states explicitly require GAAP for its agencies and local governments, some encourage it, and others openly permit another basis of accounting. For example, Arkansas Code Annotated §10-4-412 requires the use of a regulatory basis of accounting, stating, "For county and municipal financial audits, the financial statements shall be presented on a fund-basis format with, at a minimum, the general fund and the street or road fund presented separately, and all other funds included in the audit presented in the aggregate."[28] The state statute also specifically identifies the minimum statements that should be included, as well as the specific schedules and requirement for notes to the financial statements.

Fundamentally, the audit will require testing against the basis of accounting selected by the auditee, no differently than if a GAAP-conforming reporting framework were used. Some special considerations must be made however, including the basic requirement that the auditor must "evaluate whether the special-purpose financial statements are suitably titled, include a summary of significant accounting policies and adequately describe how the special-purpose framework differs from GAAP, although the differences from GAAP need not be quantified."[29] To the latter point, it may not be practicable to quantify the differences between GAAP and the special-purpose framework employed. Auditing standards do require that a complete set of financial statements be presented, but what

[28] Counties and municipalities in Arkansas are permitted to follow the more comprehensive reporting that constitutes GAAP. For example, the four largest cities in Arkansas (Little Rock, Fort Smith, Fayetteville, and Springdale) present GAAP-based financial statements. Note that GAAP-based reporting is a required element of the Certificate of Achievement for Excellence in Financial Reporting Award sponsored by the Government Finance Officers Association (GFOA).

[29] *AICPA Audit and Accounting Guide for State and Local Governments* (New York: AICPA, 2016), 637.

constitutes a complete set of statements and the comparability with a GAAP set of statements depends upon the special framework selected.

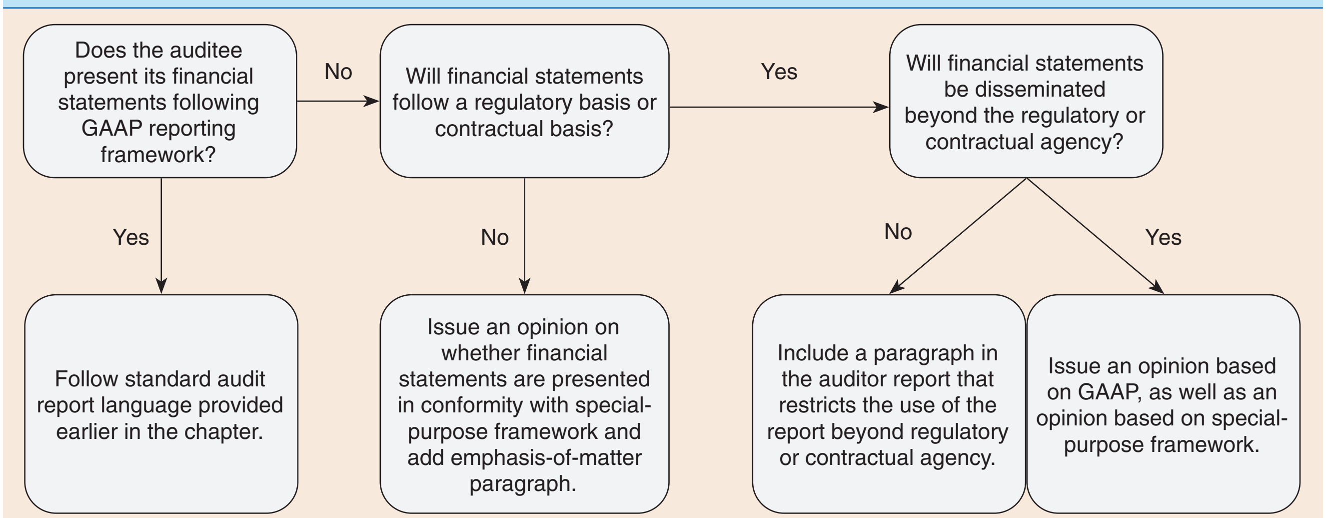
In addition, disclosures should be either the same as what would have been presented in GAAP-based notes, or similar with modifications that support the special framework. Many small governments may elect a cash-basis or a modified cash-basis as a special framework, and this should not preclude them for making appropriate disclosures about their pension plans, for example. However, to follow with the pension disclosures example, the actuarial assumptions that would support a GAAP-based measure of pension liabilities would not have to be disclosed.

Audit procedures would be designed to test whether the auditee prepared their financial statements consistent with the special-purpose framework. The audit report will also require some modifications. While the audit of an entity electing a special-purpose framework as an alternative to GAAP should issue an opinion on whether the financial statements conform with the special-purpose framework, certain language must be included to make the use of the special-purpose framework clear. Moreover, depending on which framework is elected and how the financial statements and auditor's report will be used, sometimes an additional opinion must be stated that indicates the departure from GAAP.

The AICPA Audit & Accounting Guide for State and Local Governments covers the range of possible special-purpose frameworks and audit report language in significant detail. Fundamentally, the bases of accounting are categorized as: (1) regulatory or contractual, or (2) cash, modified cash, or some other basis of accounting. Regulatory and contractual frameworks are established by either a regulatory body (e.g., the State of Arkansas identifies a regulatory basis of accounting for all county and municipal governments, as noted above) or contractual arrangement. In these instances, the special-purpose framework is established and required by another agency, generally one that has oversight (like the State Legislature) or is a funding agency and has structured the framework to be able to obtain information needed to evaluate use of funds and future funding decisions. Oftentimes, these arrangements also mean that the financial statements and the auditor's report will not be distributed beyond the regulatory or contractual agency. Whether the information is intended for distribution beyond the regulatory or contractual agency will determine the extent of the changes to the basic auditor's report examples provided earlier in the chapter.

In the case of the use of cash, modified cash, or some other basis of accounting (other than regulatory or contractual), the auditor report will include an emphasis-of-matter (EOM) paragraph. The EOM paragraph is generally titled "Basis of Accounting," and highlights the use of special-purpose framework, refers to the note in the financial statements that describes the framework, and explicitly identifies the framework as a non-GAAP basis of accounting. The auditor report will also identify management as responsible for determining that the special-purpose framework is appropriate. **Figure 16-5** provides a decision tree for determining the changes to auditor report language.

FIGURE 16-5 ■ Changes to the Audit Report Based on the Use of Special-Purpose Frameworks



Changes to the auditor report are slightly more complex when a regulatory or contractual basis is used as the special-purpose framework. As described in **Figure 16-5** and the preceding discussion, financial statements and the related auditor report often have a limited audience when a regulatory or contractual basis is used. Generally, the intended audience is the regulatory or contractual agency that specified the reporting to be used. In this case, the auditor would add an other-matter paragraph that restricts the report to this intended audience. However, if the financial statements prepared using a regulatory basis and the related auditor report are intended for more general use, such a paragraph would not be included. Instead, the auditor would express an opinion on whether the financial statements (using the special-purpose framework) are fairly presented, in all material respects in accordance with GAAP. In this case, the auditor report appears to have two opinions, one on whether the financial statements are fairly stated in conformity with GAAP, and one on whether the financial statements are fairly stated when considering the regulatory basis of accounting.

LO5 Review 16-5

Earlier discussion in this section focuses on the way individuals process information and make decisions often taking shortcuts. We can fairly easily understand that making decisions quickly (System 1 thinking) may be less desirable than applying more energy and time to decisions (System 2 thinking). However, the reverse may also be true, i.e., that we are so focused on details that we miss other more obvious details.

GuidedExamples MBC

Required:
Watch the video from this link, **https://www.youtube.com/watch?v=IGQmdoK_ZfY**, and comment on the application of System 1 and System 2 thinking. Consider how this may affect audit decision-making.

Solution on p. 16-35.

Questions

Q16-1. What aspects of an audit of a governmental or nonprofit entity are similar to an audit of a for-profit entity?

Q16-2. In what ways is the scope of the audit expanded when the client is a government or nonprofit entity?

Q16-3. What factors would necessitate the use of generally accepted government auditing standards (GAGAS) in an audit rather than generally accepted auditing standards (AICPA GAAS)?

Q16-4. What are the nine categories of requirements for conducting financial audits under the 2018 Yellow Book?

Q16-5. What are the primary ethical considerations in conducting a Yellow Book audit?

Q16-6. What independence concerns are similar between Yellow Book audits of government or nonprofit entities and GAAS audits of for-profit entities?

Q16-7. Is the preparation of the client's financial statements by the auditor considered to be an independence threat under the 2018 Yellow Book? Under what conditions may an auditor prepare the financial statements of the client?

Q16-8. What are the two elements of professional judgment?

Q16-9. How does an audit organization select its peer review team in accordance with Yellow Book quality control standards?

Q16-10. What are the types of opinions that may be issued on the financial statements of an entity audited in accordance with the 2018 Yellow Book?

Q16-11. What are the required elements of the auditor's report?

Q16-12. What are the six attributes that the 2018 Yellow Book identifies as considerations in performance audits?

Q16-13. What are the four key dates, following the Single Audit Act of 1984, significant to the evolution of federal grant requirements culminating with Uniform Guidance?

Q16-14. In the chapter discussion, an example was provided in which the Boys and Girls Clubs of America received significant grant awards from the U.S. Department of Justice, as well as grant awards from the U.S. Department of Agriculture and the U.S. Department of Health and Human Services. What are the primary programs for each agency's funding, and what do you think compliance testing might include for these programs?

Q16-15. Discuss the ways in which auditor reports under Uniform Guidance extend those of a typical GAGAS audit.

Q16-16. Discuss why the low levels of audit firm expertise in Uniform Guidance audits (also referred to as single audits) may be a violation of ethics as established by the 2018 Yellow Book.

Q16-17. What are the four cognitive biases discussed in the KPMG monograph "Elevating Professional Judgment in Auditing and Accounting: the KPMG Professional Judgment Framework"?

Q16-18. What are the steps that can be taken to mitigate cognitive decision-making biases in auditing?

Q16-19. What are the requirements for presentation of financial statements in accordance with a special-purpose framework?

Q16-20. In what instances related to the use of a special-purpose framework do auditing standards require the issuing of two opinions on the financial statements?

Assignments with the MBC in the margin are available in myBusinessCourse.
See the Preface of the book for details.

Multiple Choice

LO 2 **MC16-21.** What term is synonymous with generally accepted government auditing standards (GAGAS) and is commonly used in practice?
- *a.* Single audit
- *b.* Yellow Book audit
- *c.* Uniform Guidance audit
- *d.* OMB Circular A-133 audit

LO 2 **MC16-22.** What are the formal auditor training requirements under the 2018 Yellow Book or GAGAS?
- *a.* Forty hours of any continuing professional education (CPE) annually
- *b.* Eighty hours of any CPE every two years
- *c.* Twenty-four of 80 CPE hours every two years that are directly related to government, government auditing, or other related, specialized training
- *d.* There are no CPE requirements under the Yellow Book

LO 2 **MC16-23.** Which of the following is ***NOT*** one of the ratings that may be given as a result of a peer review of an audit organization?
- *a.* Superior
- *b.* Pass
- *c.* Pass with deficiencies
- *d.* Fail

LO 2 **MC16-24.** The concept that is associated with the point at which the magnitude of a given error would affect a financial statement user's perception of the financial condition or results of the audited entity is referred to as:
- *a.* Professional skepticism
- *b.* Opinion unit
- *c.* Objectivity
- *d.* Materiality

LO 3 **MC16-25.** What type of audit of a government or nonprofit entity is also referred to as an operational or efficiency audit?
- *a.* Compliance audit
- *b.* Performance audit
- *c.* Internal control audit
- *d.* Attestation engagement

MC16-26. Which organization conducts a large number of performance audits related to federal agencies and is referred to as the "congressional watchdog"? **LO 3**
a. Government Accountability Office (GAO)
b. Office of Management and Budget (OMB)
c. President's Council on Integrity and Efficiency (PCIE)
d. American Institute of Certified Public Accountants (AICPA)

MC16-27. Identify attestation engagements in decreasing order related to the assurance they provide: **LO 3**
a. Review, agreed-upon procedure, examination
b. Agreed-upon procedure, examination, review
c. Examination, review, agreed-upon procedure
d. Review, examination, agreed-upon procedure

MC16-28. When is a Uniform Guidance audit required? **LO 4**
a. When a government or nonprofit entity receives $500,000 or more of federal grant awards
b. When a government or nonprofit entity expends $500,000 or more of federal grant awards
c. When a government or nonprofit entity receives $750,000 or more of federal grant awards
d. When a government or nonprofit entity expends $750,000 or more of federal grant awards

MC16-29. What is the name of the repository of information from Uniform Guidance audits? **LO 4**
a. Office of Management and Budget
b. National Association of State Auditors, Comptrollers and Treasurers
c. Federal Audit Clearinghouse
d. Single Audit Repository

MC16-30. Which of the following led to the Single Audit Act in 1984? **LO 4**
a. Concerns with accountability for federal grant funds which increased during the 1960s and 1970s
b. Burdens on grantees for complying with requirements imposed by multiple federal granting agencies
c. The likelihood for gaps in coverage created by piece-meal auditing by individual federal granting agencies
d. All of the above

MC16-31. In testing associated with a Uniform Guidance audit, programs that are funded with federal grants meeting certain size and risk criteria must be tested for their controls and compliance with laws, regulations, and grant provisions. These programs are referred to as: **LO 4**
a. Major programs
b. Type A programs
c. Type B programs
d. Type C programs

MC16-32. What is the name of the classification system for the unique numbers provided for each federal funding agency and each federal program? **LO 4**
a. Catalog of federal domestic assistance (CFDA)
b. DUNS number
c. Uniform Guidance
d. Major program

MC16-33. Which of the following is the response of the auditee to the audit findings noted by the auditor for the current period? **LO 4**
a. Report on compliance for each major program
b. Schedule of findings and questioned costs
c. Summary schedule of prior audit findings
d. Corrective action plan

MC16-34. What is the name of the group established by the AICPA to provide resources to firms conducting government audits? **LO 4**
a. President's Council on Integrity and Efficiency (PCIE)
b. Government Audit Quality Center (GAQC)
c. Office of Management and Budget (OMB)
d. Audit Standards Committee (ASC)

LO 5 **MC16-35.** Cognitive psychology research identifies two types of thinking, one that is more deliberative, requires cognitive effort, and generally results in better decisions. It is called:
a. System 1 thinking
b. System 2 thinking
c. Overconfidence
d. Anchoring

LO 5 **MC16-36.** Which of the four cognitive decision-making biases identified in the KPMG monograph is noted to be the facilitator of other biases?
a. Anchoring
b. Availability
c. Overconfidence
d. Confirmation

LO 5 **MC16-37.** Which of the four cognitive decision-making biases identified in the KPMG monograph is defined as the tendency of individuals to search for evidence that supports their pre-existing views?
a. Anchoring
b. Availability
c. Overconfidence
d. Confirmation

LO 5 **MC16-38.** Which of the four cognitive decision-making biases identified in the KPMG monograph is defined as the tendency of individuals to use easily or readily accessible information regardless of its relevance?
a. Anchoring
b. Availability
c. Overconfidence
d. Confirmation

LO 5 **MC16-39.** Which of the four cognitive decision-making biases identified in the KPMG monograph is defined as the tendency of individuals to form an estimate based on a starting amount but fail to adjust sufficiently?
a. Anchoring
b. Availability
c. Overconfidence
d. Confirmation

LO 5 **MC16-40.** Which of the following describes the selection of a basis of accounting other than the reporting model (generally accepted accounting principles, GAAP) established by the standard-setting body (either FASB or GASB)?
a. Accrual
b. Modified reporting
c. Alternate accounting
d. Special-purpose framework

Data Analytics Exercise

LO 4 **E16-41.** Fundamental to the 2018 Yellow Book is the ethical concept that audit firms should be competent to perform the audits they accept. In the case of Uniform Guidance audits (previously and often still referred to as single audits), research suggests that firms with lower expertise (completing fewer such audits in a one-year period) are associated with identifying fewer audit deficiencies. To complete this exercise, download the Federal Audit Clearinghouse general file only (from **https://harvester.census.gov/facdissem/PublicDataDownloads.aspx**) for each of the years 2013, 2014, 2015, 2016, and 2017 which includes the threshold change which occurred for fiscal years beginning after December 26, 2014). You should note that "All Years" will first have to be unselected before the specified years can be selected. Import the general file into Microsoft Excel for each year and complete the following steps:

1. Determine the number of single audits performed for each year 2013–2017 (Note: we use the term single audit here to describe the audit performed when the more accurate term for fiscal years beginning after December 26, 2014 is a Uniform Guidance audit. Because the sample period encompasses pre- and post-Uniform Guidance, we use the term single audit for brevity.)

2. Find the column title Auditor EIN, which is the employer identification number (EIN) of the audit firm. Add a column called Auditor Expertise, and use the "countif" function to populate each row with the number of audits completed by the firm auditing the client. At the bottom of the Auditor Expertise column, calculate the average which represents the average number of single audits completed. Report the average for each of the years, 2013–2017. Round to the nearest whole number.
3. For the same Auditor Expertise column, use the "countif" function to calculate the number of audits completed by firms doing 10 or fewer single audits in each of the years, 2013–2017.
4. Using the metrics above, and noting that concerns with single audit quality have been noted as far back as 1997 and as recently as 2017, what can you say about auditor expertise/experience over the 2013–2017 time period?

E 16-42. Using the data downloaded from the Federal Audit Clearinghouse in E 16-41 above, evaluate the audit findings reported for 2017. Audit findings related to the financial statements include: (1) TYPEREPORT_FS, which identifies whether the opinion on the financial statements was unqualified (U) or qualified (Q), (2) REPORTABLECONDITION, which identifies whether a reportable condition was noted associated with the preparation of financial statements, (3) MATERIALWEAKNESS, which identifies whether a material weakness was noted associated with the preparation of the financial statements, and (4) MATERIALNONCOMPLIANCE, which identifies whether there was noncompliance noted that was material to the financial statements. Audit findings related to compliance (i.e., major programs) include: (1) TYPEREPORT_MP, which identifies whether the opinion on major programs was unqualified (U) or qualified (Q), (2) REPORTABLECONDITION_MP, which identifies whether a reportable condition was noted associated with major program oversight, (3) MATERIALWEAKNESS_MP, which identifies whether a material weakness was noted associated with major program oversight, and (4) QCOSTS, which identifies whether questioned costs were noted associated with federal grants (i.e., costs for which adequate documentation did not exist). **LO 4**

Using these fields from the 2017 Federal Audit Clearinghouse general file, complete the following:

1. What percentage of Uniform Guidance audits have an unqualified opinion on the financial statements?
2. What percentage of Uniform Guidance audits have no reportable conditions noted associated with financial statements?
3. What percentage of Uniform Guidance audits have no material weaknesses noted associated with financial statements?
4. What percentage of Uniform Guidance audits have no noncompliance noted to be material to the financial statements?
5. What percentage of Uniform Guidance audits have an unqualified opinion on major programs?
6. What percentage of Uniform Guidance audits have no reportable conditions noted associated with major programs?
7. What percentage of Uniform Guidance audits have no material weaknesses noted associated with major programs?
8. What percentage of Uniform Guidance audits have no noted questioned costs?
9. Based solely on these statistics from the above questions, what conclusion would you reach about how well federal grant awardees are performing? Would your answer to this question change in response to your analysis in E16-41?

E 16-43. Using the data downloaded from the Federal Audit Clearinghouse (FAC) in E 16-41 above, use of the years 2013 through 2017 to evaluate the lag between the fiscal year end of the auditees and the date that the audit information is reported to the FAC. Note that submission is required within 270 days of the end of an auditee's fiscal year-end. Retain the field "Auditor Expertise" generated in E 16-41. Complete the following: **LO 4**

1. For each year file 2013 through 2017, create a new field titled "Reporting Lag." Populate the field for each observation with the formula that calculates the difference between FACACCEPTEDATE (when the report was accepted by the FAC) and FYENDDATE (auditee's fiscal year-end). At the bottom of the "Reporting Lag" column, calculate the average number of days it takes for an auditee to file their audit report with the FAC for each of the years 2013 through 2017.
2. Comment on the trend in the reporting lag average.
3. Using only the 2017 file, create a new field titled "Auditor Expertise Category." Use a nested if function to categorize the retained "Auditor Expertise" field with a value of 5 if Auditor Expertise is greater than 100, a value of 4 if Auditor Expertise is between 51 and 100, a value of 3 if Auditor Expertise is between 21 and 50, a value of 2 if Auditor Expertise is between 11 and 20, and a value

of 1 if Auditor Expertise is 10 or fewer. Using this newly generated Auditor Expertise Category and the Reporting Lag field, create a pivot table. In the pivot table, generate the average reporting lag (number of day) by Auditor Expertise Category. Discuss any relationships noted.

Contributions Receivable Aging Exercise

LO 1 **E16-44.** Similar to audits of for-profit entities in which the adequacy of the allowance for doubtful accounts associated with accounts receivable must be evaluated, audits of government and nonprofit entities require the evaluation of receivables and the related allowance accounts. The following represents the aging of taxes receivable for McKenzie Health Foundation for the historical years ended June 30, 2020, 2019, 2018, 2017, and 2016. Contributions receivable vary significantly by year; however, contribution revenue has been fairly stable over the five-year period.

	Fiscal Year-End					
	6/30/2020	6/30/2019	6/30/2018	6/30/2017	6/30/2016	6/30/2015
Total contributions receivable	$ 1,006,000	$ 1,273,000	$ 931,000	$ 1,874,000	$ 596,000	$ 465,000
Allowance for uncollectible contributions	30,180	38,190	27,930	65,590	20,860	18,600
Total contributions revenue	21,123,000	22,064,100	20,099,500	22,117,200	21,978,800	21,654,000
Aging of contributions receivable						
0–30 days	520,000	376,000	436,000	1,474,000	596,000	435,000
31–60 days	26,000	426,000	290,000	400,000	—	30,000
61–90 days	410,000	471,000	205,000	—	—	—
>90 days	50,000	—	—	—	—	—
	$ 1,006,000	$ 1,273,000	$ 931,000	$ 1,874,000	$ 596,000	$ 465,000

Required:

1. Analyze the aging of contributions receivable and the allowance for uncollectible contributions. Your analysis should present percentages within the categories of the aging of contributions receivable. In particular, you should note whether percentage of older receivable amounts has changed over the analysis period.
2. Comment on the adequacy of the allowance for uncollectible contributions.
3. Would your approach to determining the allowance for uncollectible contributions change if you were making an analogous analysis in a for-profit entity?

Major Program Calculation Exercise

LO 4 **E16-45.** A nonprofit children's hospital has the following federal grant awards for fiscal year ended June 30, 2020.

Agency Prefix	CFDA Extension	Agency Name	Name of Federal Award	Amount Expended
12	420	Department of Defense	Walter Reed Land Conveyance	$45,400,000
93	110	Department of Health & Human Services	Maternal Child Health Federal Consolidated Programs	884,421
93	389	Department of Health & Human Services	National Center for Research Resources	5,268,831
93	847	Department of Health & Human Services	Diabetes, Digestive, and Kidney Diseases Extramural Research	6,345,074
93	865	Department of Health & Human Services	Child Health and Human Development Extramural Research	6,312,034
93	810	Department of Health & Human Services	Health Care Innovation Awards	4,990,543
20	U03	Department of Transportation	National Highway Traffic Safety Administration Safety Grants	620,865
				$69,821,768

Required:

1. Determine whether a Uniform Guidance audit must be obtained.
2. If a Uniform Guidance audit is required, determine which of the programs should be considered major. Assume that CFDA 12.420 and CFDA 93.865 are the only grant awards determined not to be low risk.
3. For major programs, what additional reporting will be required?

Evaluation of Cognitive Decision-Making Biases Exercise

E16-46. On an audit engagement, there are three primary staff assigned at the levels of manager, audit senior, and staff. **LO 5**

1. The audit manager has 10 years of experience with the firm and has been working on an audit engagement for a particular client for four consecutive years. The three most recent audits of this client have been clean; i.e., the audit opinion was unmodified and your assessment of the internal controls has suggested that, with the exception of a problem with segregation of duties, internal controls appear adequate.
2. The audit senior is new to this client, and her experience on her most recent engagement was not positive. The previous client was new to the firm, and the senior discovered that the accounting manager who had been employed by the client for 20 years had some unusual spending habits for an individual at that pay grade. With an annual salary of $75,000, the unmarried accounting manager purchased a home for $650,000 and a 2018 BMV M4 convertible with a retail price of $70,000. Nothing unusual in the accounting records was noted by the audit team, until the audit manager visited during fieldwork and discovered that receivables were overstated. The audit manager then led efforts that revealed skimming of receivables by the accounting manager, and the skimming was determined to have been ongoing for at least five years. As the audit senior on that engagement, she felt ashamed that her efforts did not reveal the fraud in the current year or in the prior three years that she was assigned to that client.
3. The staff auditor just graduated from college with a master's degree two months ago and did not participate in an internship in his undergraduate or graduate programs. His only prior work experience is working as a server at a bar and grill, where he interacted with business professionals and those interactions were generally positive. In fact, the CFO of the current audit client was a regular customer at the restaurant where he worked. The CFO was jovial and tipped well.

Required:

1. Explain how System 1 and System 2 thinking as well as the four cognitive decision-making biases may apply to each of the individuals assigned to the audit engagement.
2. What steps could each of the individuals apply in mitigating cognitive decision-making biases that are present in this case?

Solutions to Chapter 16 In-Chapter Review Questions

Review 16-1

Based on the review of the audit report for the Boys and Girls Clubs of America for the fiscal year ended December 31, 2017, it should be noted that, beyond the opinion report on the financial statements, a report was also issued on internal control over financial reporting and on tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The expanded scope of the audit is indicative of the focus on more than profit in government and nonprofit entities that receive and expend government grants. Grants often come with requirements that the auditor tests to ensure accountability with these awards, a characteristic not generally present in for-profit entities.

Review 16-2

The preparation of financial statements by the auditor is acknowledged as a threat to independence in the Yellow Book, with new specific guidance in the 2018 Yellow Book. Although it may seem logical for the auditor to prepare the financial statements, particularly for smaller clients with fewer resources to allocate to this task, it may put the auditor in the position of assuming management responsibility, a clear violation of independence standards. If the auditor meets certain safeguard provisions, he or she may prepare the financial statements. The provisions include: (1) conducting the preparation only from a client-prepared trial balance, (2) ensuring that the client agrees with any aggregation decisions (which accounts accumulate to a total presented in the aggregate in the financial statements), and (3) ensuring that the client has the capability of overseeing the preparation of the financial statements.

Review 16-3

The 2018 Yellow Book identifies six program attributes that should be considered in a performance audit. Each of these is addressed directly or indirectly in GAO's report in 2019 titled "Medicare and Medicaid: CMS Should Assess Documentation Necessary to Identify Improper Payments." First, the GAO address visibility and risks of these programs by noting that they provide coverage to nearly 120 million Americans and defining the scope of each program. Second, although the age of each program is not discussed directly, the GAO report notes that insufficient documentation has been consistent in the Medicaid program since 2011. Third, the GAO reports annual expenditures of these two programs exceed $1 trillion in fiscal year 2017, as an indication of size. Fourth, the GAO reports that concerns have previously been reported in the Medicare program related to home health and durable medical equipment (DME) payments. Fifth, the GAO reports the objectives of each program, noting that both are health-care programs and that Medicare policies are determined at the national level and Medicaid policies largely at the state level. Sixth, the GAO reports external forces including variation in state policies regarding Medicaid payments.

The GAO presents four primary recommendations as a result of its performance audit: (1) a process to evaluate and assure appropriate Medicare and Medicaid documentation, (2) ensure that medical reviews provide sufficient information about needed corrective actions to address improper payments, (3) direct states to take steps to minimize the risk that payment error rate measurement (PERM) reviews will compromise fraud investigations, and (4) promote notification to the PERM contractor regarding provider fraud investigations. CMS agreed with three of the four recommendations, but not with GAO's recommendation that Medicaid medical reviews be conducted (2).

Review 16-4

On its face, it may seem unusual that a vast majority of the Boys and Girls Clubs of America's federal funding comes from the U.S. Department of Justice (DOJ). It might be more reasonable to expect that their funding would be provided by the U.S. Department of Health and Human Services (DHHS) or the U.S. Department of Agriculture (USDA) which provides funding for meals. However, the relationship between DOJ and Boys and Girls Clubs may represent a more nuanced cost-benefit analysis at the federal level that recognizes that investment in youth may mitigate the need for funding for justice-related programs like prisons and parole programs.

Review 16-5

The video required focusing on the basketball players wearing white jerseys. The objective was to count the number of passes made by players in white. In focusing on these players, more than half of individuals who watch the video will entirely miss that a gorilla enters the screen. The point is that engaging System 2 may negate our ability to see the obvious. In the audit setting, it is important to engage System 2 when complex decision-making is required, but to also stay attuned to other factors in the audit environment that may have bearing on audit evidence.