



United States Government Accountability Office
Washington, DC 20548

June 29, 2006

Inspectors General

Subject: *Financial Audit: Guidance for Auditing Federal Employee and Veteran Benefit Payable Actuarial Estimates*

In our role as principal auditor of the consolidated financial statements of the U.S. government (CFS), we plan to use the work of the inspectors general and contracted independent public accountants who audit the agency-level financial statements. The development of the joint *PCIE/GAO Financial Audit Manual* (FAM) has provided a common framework and methodology for federal financial statement auditing. Adherence to the FAM will enable us to readily review the work of other auditors as a basis for using that work under auditing standards. We want to all be on the same page so that we are in the position to use your work.

Certain CFS line items that will be subject to our concurrent review because of their significance, such as the federal employee and veteran benefits payable line item, involve federal agencies' significant actuarial estimations. Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* applies to such estimations. In addition, Statement of Federal Financial Accounting Standard (SFFAS) No. 5 requires that federal agencies disclose specific information in their financial statements for pensions, other retirement benefits, and other postemployment benefits. Additional related audit guidance was provided in November 2004 when the American Institute of Certified Public Accountants (AICPA) issued its Statement of Position (SOP) 04-1, *Auditing the Statement of Social Insurance*,¹ effective for periods beginning after September 30, 2005. This audit guidance discusses the auditor's responsibility under SAS No. 57 and includes specific illustrative control and audit procedures that are applicable to auditing actuarial estimates to achieve SAS No. 57 objectives. Actuarial estimates for both social security and the federal employee and veteran benefit payable line item are developed by methods which calculate for the projection period covered by an actuarial valuation, the excess of (a) the present value of projected benefits of the group included in an actuarial valuation over (b) the actuarial value of program-related assets. Although the SOP 04-1 was specifically developed for use in auditing federal agencies' statements of social insurance, we consider the internal control and audit procedures discussed in SOP 04-1 to be appropriate for auditing the significant actuarial estimates in the federal employee and veteran benefit payable line item as well. Beginning in fiscal year 2006,

¹ This document is available from the AICPA at <https://www.cpa2biz.com> (last visited May 22, 2006). Once at this site, search on SOP 04-1.

we plan to use SOP 04-1 as criteria in determining the extent to which we can use audit work performed by agency auditors in this area. To the extent that the concepts and objectives of SOP 04-1 are found to be appropriate to other audit areas in the future, we will consider its use in such areas.

The purpose of this letter and the enclosure is to alert you to (1) our plan to use SOP 04-1 audit guidance in our review of agency auditors' work on federal employee and veteran benefits payable estimates that are significant to the CFS and (2) observations made during our review of selected agency auditors' work regarding such actuarial estimations as outlined in enclosure I and what additional work would need to be done to be consistent with SOP 04-1 audit guidance. We look forward to continuing to work with the federal audit community as we collectively strive to ensure the highest quality audits of federal financial statements.

We are sending copies of this letter to the Controller of the Office of Management and Budget, the Fiscal Assistant Secretary of the Department of the Treasury (Treasury), and the Chief Financial Officers of the 35 federal executive agencies required by OMB to verify and submit a closing package to Treasury.² If you have any questions regarding the information in this letter, please contact me at (202) 512-2600, or Gary Engel, Director, Financial Management and Assurance at (202) 512-3406 or engelg@gao.gov. Major contributors to this letter are Linda P. Garrison, Assistant Director, and Vera M. Seekins, Auditor-in-charge.

Sincerely yours,



Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance

Enclosure

² The closing package is a methodology developed by Treasury to directly link information from federal agencies' audited financial statements to amounts reported in the CFS. A complete closing package consists of the special purpose audit opinion, the management representation letter for the closing package, audit trail report (reclassification journal voucher report), closing package financial statement report, trading partner summary report, notes reports, and other data reports.

ADDRESSEES

The Honorable Donald A. Gambatesa
Inspector General
Agency for International Development

The Honorable Phyllis Fong
Inspector General
Department of Agriculture

The Honorable Johnnie E. Frazier
Inspector General
Department of Commerce

Mr. Thomas Gimble
Acting Inspector General
Department of Defense

The Honorable John P. Higgins, Jr.
Inspector General
Department of Education

The Honorable Gregory H. Friedman
Inspector General
Department of Energy

Mr. Bill Roderick
Acting Inspector General
Environmental Protection Agency

Mr. Carl A. Clinefelter
Inspector General
Farm Credit Administration

Mr. Kent R. Nilsson
Acting Inspector General
Federal Communications Commission

Ms. Patricia Black
Acting Inspector General
Federal Deposit Insurance Corporation

The Honorable Brian D. Miller
Inspector General
General Services Administration

The Honorable Daniel Levinson
Inspector General
Department of Health and Human Services

The Honorable Richard L. Skinner
Inspector General
Department of Homeland Security

The Honorable Kenneth M. Donohue
Inspector General
Department of Housing and Urban Development

The Honorable Earl E. Devaney
Inspector General
Department of the Interior

The Honorable Glenn Fine
Inspector General
Department of Justice

The Honorable Gordon S. Heddell
Inspector General
Department of Labor

The Honorable Robert W. Cobb
Inspector General
National Aeronautics and Space Administration

Mr. William DeSarno
Inspector General
National Credit Union Administration

Ms. Christine C. Boesz
Inspector General
National Science Foundation

The Honorable Hubert T. Bell
Inspector General
Nuclear Regulatory Commission

The Honorable Patrick E. McFarland
Inspector General
Office of Personnel Management

Mr. Robert Emmons
Inspector General
Pension Benefit Guaranty Corporation

The Honorable Martin J. Dickman
Inspector General
Railroad Retirement Board

Mr. Walter Stachnik
Inspector General

Securities and Exchange Commission

The Honorable Eric M. Thorson
Inspector General
Small Business Administration

Ms. A. Sprightley Ryan
Acting Inspector General
Smithsonian Institution

The Honorable Patrick P. O'Carroll
Inspector General
Social Security Administration

The Honorable Howard J. Krongard
Inspector General
Department of State

The Honorable Richard Moore
Inspector General
Tennessee Valley Authority

Mr. Todd J. Zinser
Acting Inspector General
Department of Transportation

The Honorable Harold Damelin
Inspector General
Department of the Treasury

The Honorable Dave Williams
Inspector General
U.S. Postal Service

The Honorable George Opfer
Inspector General
Department of Veterans Affairs

CERTAIN AGENCY AUDIT PROCEDURES OVER ACTUARIAL ESTIMATIONS
WOULD NEED TO BE EXPANDED IN FUTURE AUDITS TO BE CONSISTENT WITH
SOP 04-1 GUIDANCE

We reviewed the nature and extent of fiscal year 2004 audit work performed on the \$4 trillion consolidated financial statements of the U.S. government's (CFS) federal employee and veteran benefits payable (FEVBP) line item by independent public accountants contracted by agency inspectors general. For this effort, we compared the fiscal year 2004 audit documentation related to actuarial estimations for six selected postemployment benefit program liabilities to Statement of Position (SOP) 04-1 audit guidance. In general, we concluded that future years' audit work would need to be expanded to be consistent with SOP 04-1 audit guidance.

Specifically, for each of the six selected benefit program liabilities, we noted that audit documentation for the following areas were not consistent with SOP 04-1 §19 guidance:

- specific audit procedures performed with the assistance of an independent actuary,
- the relationship between the procedures performed with the assistance of an independent actuary and the auditor's assessments of audit risk and materiality, and
- any other significant matters related to the objectives and scope of the independent actuary's work, including any limitations on the independent actuary's procedures.

Without a clear understanding of the independent actuary's procedures and the level of assurance provided by the independent actuary's work, the auditor may inappropriately use and rely on the independent actuary's report. For example, for one of the selected benefit programs, agency audit officials informed us that they were unaware of any written program detailing the work planned by the independent actuary. The auditor advised us that they had relied on their independent actuary's professional judgment to design and perform appropriate procedures. In addition, although the agency actuary for the same agency used the concept of materiality in developing the estimate, the auditor was not aware of what the agency actuary's materiality level was and had not discussed the audit materiality with the agency actuary.

In addition, SOP 04-1 illustrative procedures refine Statement on Auditing Standards (SAS) No. 57 audit guidance. As stated in SAS No. 57, the auditor should obtain an understanding of how management developed the estimate and use one or a combination of the following approaches to evaluate the reasonableness of that estimate:

- review and test the process used by management to develop the estimates,

- develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate, and
- review subsequent events or transactions occurring prior to the completion of fieldwork.

SOP 04-1 provides more specific guidance and illustrative procedures to fulfill these SAS No. 57 requirements.

In accordance with SOP 04-1 §9, if controls over the estimation process are effective, the most practicable and efficient approach to fulfilling the auditor's responsibility under SAS No. 57 may be to review and test the estimation process used by management. SOP 04-1 §6 describes management's process as ordinarily consisting of the following activities:

1. identifying the relevant factors that affect the estimates;
2. developing assumptions that represent management's best estimate of circumstances and events with respect to the relevant factors;
3. accumulating relevant, sufficient, and reliable data on which to base the estimates;
4. determining the estimated amounts based on assumptions and other relevant factors; and
5. determining that the estimates are presented in conformity with GAAP and that disclosure is adequate.

SOP 04-1§9 specifies that if the auditor finds that controls over the estimation process are ineffective, the auditor should develop an independent expectation of the estimate, or portions of the estimate, to corroborate management's estimate, or obtain competent evidence from outside the audited agency's process that would be sufficient to support the financial statement assertions.

The five activities in management's estimation process relate to the elements in figure 1 of SOP 04-1 that depicts the process of developing social insurance estimates. We consider these same five elements to be appropriate for auditing other actuarial liability estimates. As such, during our review of fiscal year 2004 audit documentation, we looked for evidence that auditors understood the agencies' process for developing and evaluating actuarial estimates, internal control procedures, and test procedures over these five actuarial estimate elements using the illustrative controls and audit procedures. For the six selected benefit programs, audit documentation made available for our review did not include evidence that the auditors performed certain procedures illustrated in the appendix to SOP 04-1 or equivalent procedures. The following table shows the illustrative procedures by liability element that we did not see documented in our review of fiscal year 2004 audit documentation for the six selected programs.

Table 1: Number of Selected Programs Without Documented Procedures Included in the SOP 04-1's Illustrative Procedures

Liability element	SOP 04-1 Illustrative procedure not documented	Affected number of selected programs
Factors	Understand management's process for monitoring the environment to determine the effect that changes in the environment, such as legislation or health, might have on the variables selected for use in the actuarial estimate.	5
Factors	Understand management's procedures to prevent and detect the inadvertent omission of factors that should be considered in developing the actuarial estimate.	3
Assumptions	Understand the source of assumptions and how management considers and determines the effect that variation in the underlying assumptions will have on the estimates.	3
Assumptions	Understand how the agency generates, evaluates, and reviews assumptions.	3
Assumptions	Understand how the agency compares assumptions made in the current period with those of prior periods and explains or reconciles any differences.	4
Assumptions	Consider the aggregate effect of individually insignificant assumptions.	4
Model	Understand how management and other knowledgeable personnel design or select the model and how they document that model and the programs used to determine the actuarial estimate.	3
Model	Understand procedures for assigning responsibility to individuals in a manner that ensures that no single individual has the authority to read, add, change, or delete information without an independent review of that activity.	3
Model	Understand procedures for designating responsibility for significant information resources within the agency and establishing and maintaining security over such resources.	3
Model	Review documentation that describes the instructions, rules, or procedures used by the model to calculate estimates.	4
Model	Reperform calculations used in the model to translate the assumptions, data, and factors into the estimate.	5

Model	Review management's documentation of its sensitivity analysis and consider whether the results were consistent with the auditor's expectations.	4
Estimate	Inquire to determine who has final authority for reviewing and approving estimates.	4
Estimate	Understand controls related to review of estimates and the related supporting documentation.	6
Estimate	Understand controls related to the supervision of individuals who develop estimates.	6
Estimate	Compare the estimated future expenditures predicted by the actuarial model to actual expenditures for the previous fiscal year.	5
Estimate	Evaluate the reasonableness of the time period covered by the actuarial liability estimate.	4
Estimate	Determine whether the information in the actuarial liability estimate, including related disclosures, is supported by sufficient competent evidential matter.	3

Source: GAO.

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548