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American Institute of Certified Public Accountants. Not-for-Profit Organizations Committee

AICPA

American Institute of Certified Public Accountants

AUDITS of COLLEGES and UNIVERSITIES

With Conforming Changes as of May 1, 1993

Industry Audit Guide

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With Conforming Changes as of May 1, 1993

This edition of the industry audit guide *Audits of Colleges and Universities* has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. The changes made are identified in a schedule in Appendix C of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Industry Audit Guide

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NOTICE TO READERS

This industry audit guide presents recommendations of the AICPA Committee on College and University Accounting and Auditing on the application of generally accepted auditing standards to audits of financial statements of colleges and universities. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for colleges and universities. AICPA members should be prepared to justify departures from this guide.

Preface

This guide has been prepared to assist the independent auditor in auditing and reporting on financial statements of nonprofit institutions of higher education including colleges, universities, and community or junior colleges. Auditors of private or independent schools should consult the AICPA audit and accounting guide *Audits of Certain Nonprofit Organizations.* The drafting of this guide was greatly facilitated by the American Council on Education, who granted us permission to quote from and paraphrase Part 2 and the appendixes of its publication.

The Committee on College and University Accounting and Auditing wishes to express its appreciation to Howard A. Withey for his fine work in preparing the initial drafts of the guide, to Joseph V. Bencivenga and Stephen J. Gallopo, former AICPA staff personnel who worked with the Committee, and to Wilbert A. Begeman, a member of the Committee during the initial period of work on the guide. Further, the Committee acknowledges the generous cooperation and assistance provided by the National Association of College and University Business Officers (NACUBO) through their assignment of Clarence Scheps and Robert B. Gilmore as consultants to this Committee. In addition, W. Harold Read, chairman of NACUBO's Accounting Principles Committee, gave generously of his time in commenting on and discussing topics dealt with in the guide.

Committee on College and University Accounting and Auditing

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Chapter 1

Introduction

1.01 Proper accounting and financial reporting have been of primary concern to college and university business officers. Literature dealing with these matters has been published since 1911. The most recent of these publications is *College and University Business Administration.* This revised edition (referred to in this guide as the Manual) combines in one volume the matters covered in previous volumes. As in earlier editions, the national committee, which prepared the text for the Manual, was comprised of individuals from the various associations of business officers, the U.S. Office of Education, the American Council on Education, the AICPA, and individuals acting as special consultants to the Committee.

1.02 Much of the material in this guide is presented as it appears in the Manual. In some instances, however, the guide recommends practices, both accounting and reporting, which differ from the Manual or which clarify or expand practices recommended by it. Also, some disclosure requirements recommended by the Accounting Principles Board, Financial Accounting Standards Board, and Governmental Accounting Standards Board are not mentioned in the Manual. Significant items added to the guide or requiring accounting or reporting practices which are different from those recommended in the Manual are listed below.

Summary of Significant Changes

1.03 *Basic Financial Statements.* Certain reporting practices differing from those included in the Manual are discussed in chapter 11 and illustrated in the financial statements in Statement of Position (SOP) 74-8, *Financial Accounting and Reporting by Colleges and Universities* [Appendix A].

1.04 *Investment Performance.* Disclosure of the total performance of the investment portfolio is discussed in Chapter 2 and illustrated in the notes to the financial statements in SOP 74-8 [Appendix A].

1.05 *Investments, Exclusive of Physical Plant.* Current market or fair value as an alternative to cost in reporting the carrying value of investments is discussed in chapter 2.

1.06 *Depreciation.* While agreeing with the premises and conclusions of the Manual with respect to depreciation accounting, the guide permits the reporting of depreciation expense in the plant fund section of the statement of changes in fund balances as stated in chapter 2. FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations,* as amended, requires not-for-profit organizations to recognize the cost of using up the future economic benefits or service potentials of their long-lived tangible assets—depreciation—and to disclose:

a. Depreciation expense for the period
b. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date
c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date
d. A general description of the method or methods used in computing depreciation for major classes of depreciable assets.

1.07 GASB Statement No. 8, *Applicability of FASB Statement No. 93, "Recognition of Depreciation by Not-for-Profit Organizations," to Certain*

State and Local Governmental Entities, provides that governmental colleges and universities should not change their accounting and reporting for depreciation of capital assets as a result of FASB Statement No. 93. Governmental colleges and universities are not precluded from depreciating their capital assets by reporting a depreciation allowance in the balance sheet and a provision for depreciation in the statement of changes in the balance of the investment-in-plant fund subsection of the plant funds group. (See paragraph 2.22).

1.08 *Funds Held in Trust by Others.* Funds held in trust by others may be included in the financial statements under the circumstances described in chapter 2.

1.09 *Institutions Operated by Religious Groups.* Chapter 2 includes guidelines for institutions operated by religious groups with respect to the accounting entity, facilities made available by religious groups, and the monetary value of contributed services.

1.10 *Endowment Income Stabilization Reserve.* Endowment income stabilization reserves are at variance with generally accepted accounting principles, and the manner in which any established reserve may be eliminated is set forth in chapter 4.

1.11 *Endowment Fund Investment Gains.* As discussed in chapter 8 and illustrated in SOP 74-8 [Appendix A], the guide clarifies and expands upon the position taken in the Manual with respect to accounting for gains and losses of investments of endowment and similar funds and discusses statement presentation when management uses the "total return" investment concept.

1.12 *Expired Term Endowments.* As stated in chapter 8 and illustrated in the financial statements in SOP 74-8 [Appendix A], upon termination, the unrestricted principal of term endowment funds should be treated as new fund additions to unrestricted current funds rather than as transfers, as recommended in the Manual.

1.13 *Debt Service on Educational Plant.* The Manual treats mandatory debt service provisions relating to educational facilities as transfers and classifies similar provisions relating to auxiliary enterprise facilities as expenditures. The guide provides for a consistent treatment in both cases as described and illustrated in SOP 74-8 [Appendix A].

1.14 *Loan Fund Matching Grant.* Mandatory transfers from current funds to loan funds to match gifts or grants are treated separately from nonmandatory transfers as described and illustrated in SOP 74-8 [Appendix A].

1.15 *Nonmandatory Transfers of Unrestricted Current Funds.* The guide in SOP 74-8 [Appendix A] distinguishes between mandatory provisions, exemplified by the two preceding items, and nonmandatory transfers, and in chapter 11 requires that any statement of current funds revenues, expenditures, and other changes include all current funds transfers.

1.16 *Provision for Encumbrances.* As stated in chapter 2, accounting for encumbrances should be in accordance with the accrual basis of accounting so that expenditures include only amounts associated with goods and services received and so that liabilities include only the unpaid amounts associated with such expenditures.

1.17 *Annuity Funds.* The actuarial method of accounting for annuity funds, providing for the determination of annuity liabilities based on a life expectancy basis, is described in chapter 10 and illustrated in SOP 74-8 [Appendix A].

1.18 *Agency Funds.* Agency funds should not be included in the statement of changes in fund balances, as set forth in chapter 10.

1.19 *Pledges, Excluding Grants.* The guide requires disclosure of pledges, as discussed in chapter 2.

1.20 *Current Funds Revenues and Expenditures.* Certain changes in categories and groupings of current funds revenues and expenditures have been made in SOP 74-8 [Appendix A].

1.21 *Accounting Changes and Disclosure Requirements Promulgated by the Body Designated by the Council of the American Institute of Certified Public Accountants.* Additional disclosure requirements occasioned by pronouncements of the Accounting Principles Board which are not mentioned in the Manual are illustrated or referred to; these requirements include reference to such matters as employee benefit plans and long-term leases. Pronouncements issued by the Financial Accounting Standards Board after this guide is issued which affect the financial statements of nongovernmental educational institutions may impose changes in accounting and further disclosure requirements which, of course, would have to be met. Pronouncements issued by the Governmental Accounting Standards Board after this guide was originally issued which affect the financial statements of governmental institutions may impose changes in accounting and further disclosure requirements which would also have to be met.

Effective Date

1.22 The guide shall be effective for all fiscal years beginning after June 30, 1973.

Chapter 2

General Accounting Principles and Audit Procedures

2.01 Service, rather than profits, is the objective of an educational institution; thus, the primary obligation of accounting and reporting is one of accounting for resources received and used rather than for the determination of net income. Frequently there is no relationship between the fees charged and the actual expenditures for program services. In addition, philanthropic sources often specify the particular program service or fund to which their contributions are to be applied. Furthermore, nonexpendable gifts must sometimes be maintained to produce income to be used for general or specific programs. Some nonexpendable resources are also restricted as to use, e.g., loans to students, faculty, or staff. In order to account properly for a diversity of resources and their use, there has developed, over a period of years, the principles and practices of "fund accounting."

General Accounting Principles

2.02 *Fund Accounting.* Fund accounting is the procedure by which resources for various purposes are classified for accounting and reporting purposes in accordance with activities or objectives as specified by donors, in accordance with regulations, restrictions, or limitations imposed by sources outside the institution, or in accordance with directions issued by the governing board.

2.03 A fund is an accounting entity with a self-balancing set of accounts for recording assets, liabilities, a fund balance, and changes in the fund balance. Separate accounts are maintained for each fund to insure observance of limitations and restrictions placed on the use of resources. For accounting and reporting purposes, however, funds of similar characteristics are combined into fund groups.

2.04 In some instances, legal provisions, regulations, and the like pertaining to certain funds may require accounting and reporting practices which may be at variance with generally accepted accounting principles. The Committee recognizes that in these instances such legal and regulatory provisions must take precedence whenever a conflict between the two exists. Such restrictions, however, do not obviate generally accepted accounting principles for the purpose of reporting financial position, changes in fund balances, and current funds revenues, expenditures, and other changes. In instances where financial statements are not presented in conformity with generally accepted accounting principles, the independent auditor would be precluded from expressing an unqualified opinion and should refer to SAS No. 58, *Reports on Audited Financial Statements,* for guidance with respect to the appropriate wording to be used in such an opinion. Paragraphs 22 through 30 of SAS No. 62, *Special Reports,* discuss reporting on special-purpose financial presentations to comply with contractual agreements or regulatory provisions that are intended solely for the use of the parties to the agreement, regulatory bodies, or other specified parties.

2.05 The fund groups usually encountered in an educational institution are as follows:

- Current funds
- Loan funds

- Endowment and similar funds
- Annuity and life income funds
- Plant funds
- Agency funds

2.06 In subsequent chapters, definitions of each of the above are followed by descriptions of the accounting principles and reporting practices unique to a particular fund group. Accounting principles and reporting practices applicable to several or all fund groups follow.

2.07 *Basic Financial Statements.* Financial reporting utilizes three basic types of statements, namely (a) balance sheet, (b) statement of changes in fund balances, and (c) statement of current funds revenues, expenditures, and other changes. See chapter 11 for further explanation and SOP 74-8 [Appendix A] for illustrations of the basic financial statements.

2.08 *Externally Restricted vs. Internally Designated Funds.* A clear distinction between the balances of funds which are externally restricted and those which are internally designated within each fund group should be maintained in the accounts and disclosed in the financial reports.

2.09 *Accrual Accounting.* The accounts should be maintained and reports prepared on the accrual basis of accounting. Revenues should be reported when earned and expenditures when materials or services are received. Expenses incurred at the balance sheet date should be accrued and expenses applicable to future periods should be deferred. However, certain deferrals and accruals, such as investment income and interest on student loans, are often omitted. Nevertheless, the only basis for their omission should be that the omission does not have a material effect on the financial statements. Revenues and expenditures of an academic term, such as a summer session, which is conducted over a fiscal year end, should be reported totally within the fiscal year in which the program is predominantly conducted.

2.10 Encumbrances representing outstanding purchase orders and other commitments for materials or services not received as of the reporting date should not be reported as expenditures nor be included in liabilities in the balance sheet. Designations or allocations of fund balances or disclosure in the notes to the financial statements should be made where such commitments are material in amount. Failure to disclose the distinction between true liabilities and encumbrances which are not true liabilities could result in the presentation of misleading information to state authorities, regulatory bodies, budget commissions, and others.

2.11 *Gifts, Bequests, and Grants.* Gifts, bequests, grants, and other receipts restricted as to use by outside grantors or agencies are recorded as additions directly in the fund group appropriate to the restricted nature of the receipt. Unrestricted gifts, bequests, and grants are recorded as unrestricted current funds revenues. (See SOP 74-8 [Appendix A].)

2.12 Pledges of gifts, including uncollected subscriptions, subscription notes, and estate notes, should be disclosed in the notes unless they are reported in the financial statements. The notes to the financial statements should disclose the gross amounts by time periods over which the pledges are to be collected and related restrictions, if any, as to use.

2.13 If the pledges are reported in the financial statements, they should be accounted for at their estimated net realizable value in the same manner as gifts received (except as to asset classification, for which pledges would be reported as a receivable), and credited to unrestricted revenues, deferred income, current restricted funds, plant funds, etc., as appropriate. The estimated net realizable value comprehends the present value of long-term pledges and reductions for any allowance for uncollectible pledges.

2.14 Grant awards not yet funded and for which the institution has not yet performed services should not be considered as assets to be accounted for in the financial statements. However, the total amount of such uncollected grant awards at the balance sheet date may be disclosed in the notes to the financial statements.

2.15 *Investments Exclusive of Physical Plant.* Investments purchased usually are reported in the financial statements at cost and investments received as gifts at the fair market or appraised value at the date of gift, unless there has been an impairment of value not considered to be temporary. Investments in wasting assets, other than institutional plant, usually are reported net of allowance for depreciation or depletion (see also paragraph 2.22, "Depreciation of Physical Plant").

2.16 As a permissible alternative, investments, exclusive of physical plant, may be reported in the financial statements at current market value or fair value, provided this basis is used for all investments of all funds. When using this alternative, unrealized gains and losses should be reported in the same manner as realized gains and losses are reported under the cost basis.

2.17 Interfund sales of investments should be recorded in the purchasing fund at fair market value. The difference between cost or carrying value and fair market value should be accounted for in the selling fund in the same manner as realized gains and losses. The financial statements or notes should set forth the total performance (i.e., yield and gains and losses) of the investment portfolio based on cost and market value.

2.18 Investments of various funds may be pooled unless prohibited by statute or by terms of the gifts. Accounting for pooled investments should provide for both the equitable distribution of income and the means of determining the equitable share of the participating funds in both realized and unrealized gains or losses on investments.

2.19 Proper determination of equities and the basis of income distribution require that pooled investment funds be administered on a basis utilizing market values on a share or unit plan. This determination is made through the use of memorandum records instead of recording each investment at market value in the accounts.

2.20 Premiums paid on interest-bearing obligations held as long-term investments should be amortized, and provision should be made for the accumulation of discounts unless inappropriate because of default or quality of the bonds.

2.21 In order to maintain the distinction between income and principal of endowment and similar funds, depreciation or depletion should be provided on wasting assets held as investments of these funds. Gains and losses on investments of all fund groups are treated as revenues or as additions to or deductions from the owning fund balance.

2.22 *Depreciation of Physical Plant.* Depreciation expense related to depreciable assets comprising the physical plant is reported neither in the statement of current funds revenues, expenditures, and other changes nor in the statement of changes in unrestricted current funds balance. The reason for this treatment is that these statements present expenditures and transfers of current funds rather than operating expenses in conformity with the reporting objectives of accounting for resources received and used rather than the determination of net income. Depreciation allowance, however, may be reported in the balance sheet and the provision for depreciation reported in the statement of changes in the balance of the investment-in-plant fund subsection of the plant funds group. FASB Statement No. 93, *Recognition of Depreciation by Not-for-Profit Organizations,* as amended, requires not-for-profit organizations to recognize the cost of using up the future economic benefits or service potentials of their long-lived tangible assets—depreciation—and to disclose:

a. Depreciation expense for the period
b. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date
c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date
d. A general description of the method or methods used in computing depreciation for major classes of depreciable assets.

2.23 GASB Statement No. 8, *Applicability of FASB Statement No. 93, "Recognition of Depreciation by Not-for-Profit Organizations," to Certain State and Local Governmental Entities,* provides that governmental colleges and universities should not change their accounting and reporting for depreciation of capital assets as a result of FASB Statement No. 93. Governmental colleges and universities are not precluded from depreciating their capital assets by reporting a depreciation allowance in the balance sheet and a provision for depreciation in the statement of changes in the balance of the investment-in-plant fund subsection of the plant funds group. (See paragraph 2.22).

2.24 *Interfund Borrowings.* Interfund borrowings of a temporary nature should be reported as assets of the fund group making the advances as well as liabilities of the fund group receiving the advances.

2.25 Advances from unrestricted current funds or quasi-endowment funds to other fund groups should be recorded as permanent transfers unless there is expectation of repayment within a reasonable period of time. Advances from donor-restricted plant funds and endowment (or term endowment) funds to other funds may be improper. Except for temporary advances, usually up to one year, the term of borrowings and repayments should be disclosed. Where one bank account is maintained for more than one fund, the cash balance may ordinarily be split among the funds in the statements. If a fund in effect has a cash overdraft in such bank account, an interfund borrowing should be shown.

2.26 *Funds Held in Trust by Others.* Funds held in trust by others are resources neither in the possession nor under the control of the institution, but held and administered by outside fiscal agents, with the institution deriving income from such funds. These funds preferably should not be included in the balance sheet with other funds administered by the institution, but should be disclosed parenthetically in the endowment and similar funds group in the balance sheet or in the notes to the financial statements. However, if the institution has legally enforceable rights or claims, including those as to income, such funds may be reported as assets, properly described, in the financial statements. The value of such funds should be supported by annual trust reports available to the institution.

2.27 If the funds were established under irrevocable trusts with no discretionary powers resting with the trustees as to distribution of income, the income should be included either as endowment income with a notation of the amount, or should be separately stated. If the funds were established under revocable trusts, or if the trustees have discretion as to the amounts to be distributed to the beneficiaries, the discretionary amounts of income are tantamount to gifts and should be so reported with disclosure of the amounts.

2.28 *Institutions Operated by Religious Groups.* Accounting records and reporting must be adequately segregated from those of the sponsoring religious group so that the educational entity is in fact accounted for as a separate entity. Facilities made available to the educational entity by the religious group should be disclosed in the financial reports together with any related indebtedness.

2.29 The monetary value of services contributed by members of the religious group should be recorded in the accounts and reported in the financial statements. The gross value of services performed (determined by reference to lay-equivalent salaries by type of personnel) should be recorded as expenditures by department or division, following the same classification as other expenditures, and a like amount should be recorded as gift revenue. The gift revenue should be reduced by the amount of maintenance, living costs, and personal expenses incurred which are related to the contributing personnel and have no counterpart in a lay employee relationship.

2.30 In some cases, checks are drawn to the religious group and charged to expenditure accounts in the same manner as other payroll checks. The religious group then makes a contribution to the institution, which is recorded as a gift. The determination of the contribution would rest with the religious group, since the latter is a separate entity.

2.31 In some cases these institutions inform the reader of the financial report as to the relative value of such contributed services by comparison with the average return on endowment fund investment. Such information should be limited to the notes to the financial statements, and the imputed capitalized value of such contributions should not be reflected in the balance sheet.

Internal Control Structure

2.32 The internal control structure of an educational institution is initiated by the charter or certificate of incorporation, bylaws, and other regulations governing the conduct of the entity. These basic controls are further delineated through organization charts, charts of accounts, accounting manuals, and other documents dealing not only with finance and accounting but with faculty and other educational procedures, research procedures, work programs, etc. Because of the unique characteristics of each educational institution, it is not possible to suggest a uniform or standard internal control structure. In the chapters which follow, internal control considerations applicable to specific areas are discussed.

General Audit Procedures

2.33 General audit procedures and inquiries appropriate to an educational institution may include the following:

1. Determination as to whether required meetings of the governing board have been held.
2. Determination as to whether resolutions of the governing board requiring action in accounting and financial matters have been acted upon, and whether financial matters requiring action of the governing board have been approved.
3. Review of federal report of tax-exempt organizations (Form 990) and federal tax-exemption letter, and notation of current compliance with conditions governing exemption.

4. Examination of support, generally pledge cards, for pledges. Other audit procedures may include investigation of credit standing of pledgors, aging of accounts, review of collections, and confirmation from pledgors.
5. Review of correspondence relating to gifts, with notation of the amount and nature of any restrictions.
6. Comparison of total gifts received in the current period with prior periods and with fund-raising estimates prepared by management. Investigation of substantial differences. Consideration of test confirmation of gifts received.
7. Determination of propriety of interfund transfers, particularly with respect to those involving restricted funds.
8. Determination of collectibility of interfund advances.

2.34 Additional audit procedures applicable to specific areas are discussed in the following chapters.

Chapter 3

Unrestricted Current Funds

3.01 The current funds group includes those economic resources of the institution which are expendable for any purpose in performing the primary objectives of the institution, i.e., instruction, research, extension, and public service, and which have not been designated by the governing board for other purposes. Resources restricted by donors or other outside agencies for specific current operating purposes are accounted for as restricted current funds (see chapter 4).

3.02 Unrestricted current funds designated by the governing board to serve as loan or quasi-endowment funds, or to be expended or appropriated for plant purposes, are included in the sections dealing with such funds. A separate fund subgroup may be established for the unrestricted current funds of auxiliary enterprises.

3.03 The balance sheet accounts of unrestricted current funds consist of the usual asset and liability accounts such as cash, short-term investments, accounts and notes receivable, inventories, prepaid expenses and deferred charges, accounts and notes payable, accrued liabilities, deposits, deferred revenues, and fund balances. Balances resulting from interfund borrowings may be either assets or liabilities.

3.04 The fund balance of unrestricted current funds represents the difference between the assets and liabilities, including deferred revenues, of unrestricted current funds. The fund balance may be subdivided to reflect portions applicable to auxiliary enterprises, gifts allocated to future periods or reserved for specific purposes, purchase orders outstanding, budget balances carried forward or other allocations of the governing board, and the unallocated balance.

3.05 Changes in the balances of unrestricted current funds include the gross amounts of all unrestricted revenues and expenditures applicable to the reporting period as determined in accordance with the accrual basis of accounting; transfers to and from other funds for the period; and transfers between unallocated and allocated subaccounts where such subaccounts are maintained.

3.06 The governing board may elect to transfer unrestricted funds to other fund groups, such as to quasi-endowment funds to serve as endowment until some other purpose is determined as more suitable; to loan funds to supplement governmental appropriations for loan funds; or to plant funds for expansion or rehabilitation or for debt retirement. Similarly, the governing board may elect to return any balances of designated funds appearing in other fund groups to unrestricted current funds.

3.07 The governing board may also elect to set aside unrestricted current funds for specific future operating purposes. Such allocations represent a subdivision of unrestricted current funds balance. Expenditures incurred for the stated purposes are charged to the expenditure accounts appearing in the statement of current funds revenues, expenditures, and other changes.

3.08 The composition of the unrestricted current funds balances (auxiliary enterprises, reserve for encumbrances, allocations, etc.) may be disclosed either in the balance sheet or in the statement of changes in fund balances.

Internal Control Structure

3.09 Internal control structure policies and procedures relevant to unrestricted current funds are similar to those applicable to commercial entities. In addition to the comments on basic internal control in chapter 2, some procedures of particular importance to educational institutions are as follows:

1. Retention of gift documents and other supporting data and recheck of gift and grant documents.
2. Approval of scholarship and other credits to students' accounts.
3. Billing procedures for student fees, auxiliary services, and rentals (including occupancy) and assignment records.
4. Control of tickets, conformity with budgets, and reasonableness of gross margins of auxiliaries.
5. Prenumbered tickets for deposits and advance payments.
6. Coordination and independence of functions of purchasing, budgeting, approvals, and payments for both materials and services.
7. Personnel appointment procedures and records for both academic and nonacademic personnel.
8. Coordination of appointment procedures with budgetary controls.

Audit Procedures

3.10 Audit tests of unrestricted current funds accounts do not vary materially from procedures in audits of commercial entities. Procedures of particular importance to educational institutions may include:

1. Summarization of cash accounts by funds and performance of the usual audit tests simultaneously. Consideration as to whether tests of cash funds, investments, notes receivable, etc. should be carried out at the same time.
2. Reconciliation and comparison of interfund accounts and determination as to whether cash offset is practicable and reasonable.
3. Review of vouchers payable and outstanding purchase orders, and institution's determination of charges to budgetary accounts as between materials and services received and those representing commitments for merchandise or services to be received.

Chapter 4

Restricted Current Funds

4.01 The restricted current funds group consists of those funds expendable for operating purposes but restricted by donors or other outside agencies as to the specific purpose for which they may be expended. Such externally imposed restrictions are to be contrasted with internally created designations imposed by the governing board on unrestricted funds. The circumstances and evidence relative to restrictions may not be clear and may require advice of legal counsel, management and independent auditor judgment, insight, and discretion. Nevertheless, the distinction between the balances of externally restricted and internally designated, but otherwise unrestricted funds, must be maintained in the accounts and disclosed in the financial reports.

4.02 The assets of restricted current funds are almost exclusively of a liquid character such as cash, investments, accounts receivable (including unbilled charges), and amounts due from other funds. The assets are sometimes combined with those of unrestricted current funds for reporting purposes. If the assets are combined, any intrafund borrowings within current funds should be disclosed. Regardless of whether or not the assets are segregated, restricted current fund balances should be disclosed separately in the financial statements and appropriately classified.

4.03 The following list illustrates major subgroupings:

1. Restricted income from endowment funds. The degree of detail required to account for the income depends upon the nature of the restrictions.
2. Gifts restricted for operating purposes, such as scholarship grants, gifts for purchase of library books, etc.
3. Grants from private or governmental sources for research, training, or other sponsored programs.
4. Appropriations from governmental sources for operational purposes where restrictions as to use have been imposed by the appropriating body.
5. Endowment income stabilization reserve. Some institutions have created such reserves by setting aside a portion of the income earned by pooled investments. In any given year, the distribution to the income accounts of participating funds from pooled earnings was made at a fixed or predetermined rate more or less than the actual earnings for the period. The difference was added to or deducted from the reserve for stabilization of income.

4.04 As compared to other accounting and reporting practices recommended elsewhere in this guide, a stabilization reserve established in the manner described above has several deficiencies:

1. The stabilization reserve can represent undistributed income which, if distributed, would be attributable to both restricted and unrestricted funds. The true nature of the reserve, therefore, cannot be accurately reported in the financial statements.
2. To the extent that the reserve includes income earned during the fiscal year attributable to unrestricted current funds but not distributed, unrestricted current funds revenues will be understated. Conversely, distributions from the reserve in excess of current period

earnings result in an overstatement of unrestricted current funds revenues.

3. Questions might arise concerning the propriety of the governing board in withholding amounts of income earned for the benefit of restricted current funds, but not distributed thereto.

4.05 If the endowment income stabilization reserve practice is followed, the independent auditor should qualify his opinion with respect to the fairness of presentation of material amounts of unrestricted funds included in the reserve, as well as to material differences between income distributed and income earned during the period.

4.06 Further additions to such an income stabilization reserve should not be made and proper disposition of the reserve balance should be effected. When the practice of using this reserve is discontinued, the existing reserve balance should be allocated back to the funds from which it was withheld. In the event precise information is not available for such reallocation, reasonable estimates should be used.

4.07 Additions to restricted current funds include (1) restricted gifts for specific operating purposes; (2) restricted endowment income earned or distributed; (3) contracts, grants, and appropriations received from private organizations or governments for research, public service, or other restricted purposes; and (4) income and gains from investments of current restricted funds. Charges to the restricted funds balances include (1) expenditures charged to the funds or amounts transferred to revenues to offset appropriate expenditures; (2) refunds to donors and grantors; (3) losses on investments of current restricted funds; and (4) transfers to unrestricted revenues representing indirect cost recoveries on sponsored programs. The changes during the reporting period are presented in the statement of changes in fund balances.

4.08 Institutions may use a columnar statement of current funds revenues, expenditures, and other changes to distinguish between unrestricted and restricted revenues and expenditures. If such a statement is presented, an amount equivalent to the expenditures is reported as restricted revenues, while the expenditures are classified by functional program similar to the classification of unrestricted expenditures. Some institutions, however, do not distinguish restricted from unrestricted sources of revenues in the statement of current funds revenues, expenditures, and other changes. In this case, the major sources of restricted revenues should be disclosed.

Internal Control Structure

4.09 Internal control structure policies and procedures relevant to the transactions in restricted current funds may include the use of the following accounting and management procedures:

1. Establishment of a separate fund subgroup for restricted current funds consisting of assets, liabilities, fund balances, and addition and deduction accounts for each fund balance.
2. Establishment of appropriate budgetary procedures for the expenditures and transfers from these funds.
3. Maintenance of adequate gift records indicating the authorized use of restricted funds to support classification in the accounts of the institution.
4. Establishment of an adequate acknowledgment procedure covering the receipt of gifts.

5. Submission of statements of financial transactions to grantors and donors.

Audit Procedures

4.10 Auditing of asset and liability accounts of restricted current funds does not present substantial differences from auditing of similar accounts in other organizations. There are, however, important additional audit tests that should be considered in the auditing of the fund balances themselves and the changes therein. These procedures include the following:

1. Examination of selected expenditure vouchers and other documentation to determine that the use of the resources is in conformity with gift and grant documents and that the proper disposition of the fund balance is made upon completion of the project or grant.
2. Review of distribution of endowment income to ascertain whether donor restrictions are being observed.
3. Tests of abstracts of gift and grant documents for conformity with original documents.
4. Review of financial data furnished to grantors and donors.
5. Substantiation of distributions from the income account of the pooled endowment fund.

Chapter 5

Current Funds Revenues

[5.01—5.20] [Superseded by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities.* See Appendix A.]

Internal Control Structure

5.21 Internal control structure policies and procedures relevant to current funds revenues are similar to many of the procedures applicable to commercial entities. Some of the procedures of particular importance to educational institutions are as follows:

1. Budgetary control over recorded revenues, including comparison with budget estimates and analysis of significant variations.
2. Control over revenues by recording on the accrual basis.
3. Independent control over issuance of credits, allowances (including scholarships), and other adjustments.
4. Procedures for receiving and acknowledging gifts and grants.

Audit Procedures

5.22 A variety of audit tests are generally applicable in reviewing revenue items. Because of the wide variations among educational institutions, it is not practicable to list all the steps used in practice. The following tests are examples of procedures to be considered:

1. Review of each major revenue account and comparison with prior period and budget estimate and determination of reasons for any significant variations.
2. Comparison of revenues with related statistical reports of enrollment, occupancy, meals served, etc., prepared by departments or individuals not related to the revenue-recording or cash-receiving functions.
3. Review and evaluation of the data underlying gifts, grants, and bequests, including gift documents, correspondence, receipt acknowledgments and notifications of the grant awards, minutes of the governing board, and comparison by type or nature with amounts for prior periods.
4. Review of the latest indirect cost computation, and review of the reports on examination of direct and indirect costs by representatives of grantors. Review of the separation of functions methods of apportionment of applicable expenses in cases where the institution is administering large grants involving research centers or similar operations.
5. Review of gross margin percentages of auxiliaries and comparison with those for prior periods and budgets.
6. Tests of records in support of revenues from sporting events including ticket sales records, ticket numbers, free tickets, tax reports, and contracts with other institutions.

Chapter 6

Current Funds Expenditures and Transfers

[6.01—6.22] [Superseded by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*. See Appendix A.]

Internal Control Structure

6.23 Internal control structure policies and procedures relevant to expenditures of educational institutions includes many of the practices and procedures common to commercial entities. Questions of particular importance in reviewing internal control in an educational institution may include the following:

1. To what extent are budgetary procedures used to exert control over expenditures for educational as well as capital purposes?
2. Are management reports designed to conform with the concept of "responsibility reporting," that is, reporting of expenditures according to those who are accountable for their control?
3. Have the cost adjustments made by research or other grantors been reasonable considering the related cost claimed by the institution?
4. Are all expenditures recorded through liability or commitment accounts, thus affording a primary control over payments?

Audit Procedures

6.24 The audit program for expenditures of educational institutions will include the tests appropriate to many other kinds of organizations. In addition, the following procedures may be appropriate.

1. Review of procedures for evaluating and reporting contributed services.
2. Review of procedures for evaluating and reporting (for tax, insurance, and other purposes) lodging, meals, or other perquisites furnished to employees.
3. Comparison of expenses with prior year expenses and with budget authorizations, and explanation of significant variations.
4. Analysis of campaign and fund-raising costs. If costs of endowment and building campaigns have been charged against the proceeds of such campaigns, determine that such charges are proper.
5. Consideration of special audit emphasis in the payroll, purchasing, and disbursement areas in view of the following typical factors and tendencies of educational institutions:
   a. Payroll—Salaries and wages usually constitute a very significant portion of total expenditures. If controls over distribution of payroll checks are weak, surprise control of payroll distributions, review and comparison of payroll check endorsements with employee signatures in personnel records, discussions with department heads about selected employees, and review of student-faculty ratios and trends should be considered.
   b. Purchasing and disbursements—Often the procedures surrounding initiation of purchases, receipt of goods and services, and the ultimate payment of invoices are decentralized. If controls over these activities are weak, audit emphasis on approvals and

support for disbursements, including visits to selected departments to examine or discuss with appropriate officials specific materials or services received, should be considered.

Chapter 7

Loan Funds

7.01 The loan funds group consists of loans to students, faculty, or staff, and of resources available for such purposes. The terms of gift agreements usually specify that the funds operate on a revolving basis, i.e., repayments of principal and interest are loaned to other individuals. Some loan funds are created on a temporary basis and require that repayments and interest be returned to the grantors. The grants may also designate that the obligation to repay all or part of the loan will be forgiven under certain circumstances. Some gift agreements may also designate the curriculum and geographical domicile of the student borrowers and the financial status of the borrowers.

7.02 The assets of loan funds may consist of cash, notes receivable for loans granted, and temporary investments of cash available for loans. See chapter 2 for a discussion of accounting for investments.

7.03 Notes receivable for loans should be carried at face value less allowance for doubtful loans. Provision for doubtful loans should be charged to the equity account of the specific loan fund. The amount of interest on loans is usually determined either by the donor or the regulations prescribed by the institution, and interest earnings usually should be credited to the specific loan fund equity account.

7.04 Liabilities which appear in the balance sheet of loan funds might consist of amounts due collection agencies for collection fees, amounts due unrestricted funds for unremitted share of administrative costs, and amounts due as refunds on refundable loan funds.

7.05 Changes in loan funds generally consist of gifts, bequests, and government advances restricted to use for loan purposes, interest on loan notes, income from endowment funds restricted to loan purposes, income and gains and losses on investments of loan funds, loans written off or deductions to provide for appropriate allowances for uncollectible loans, administrative and collection costs, transfers to and from other fund groups, and refunds to grantors. Such transactions should be reported in the statement of changes in fund balances of loan funds.

7.06 Interest on loans to students is not ordinarily recorded in the loan funds until collected. In the past, the Department of Education has not recognized loan losses or provisions for loan losses on government loans. Such omissions are rarely significant to the institution's overall financial statements. However, when the auditor reports separately upon government loan funds, he should consider the materiality of any such omissions in relation to the financial statements of government loan funds and their possible effect upon his opinion on the statements of those funds.

7.07 For appropriate disclosure, the source of the funds available for loan purposes at the balance sheet date should be separately identified in the financial statements, such as donor- and governmental restricted loan funds including funds provided by mandatory transfers required for matching purposes, unrestricted funds designated as loan funds, and funds returnable to the donor under certain conditions.

7.08 The financial statements may identify resources available for loans to students separately from those for faculty and staff and should distinguish those which may be reverted to other purposes.

Internal Control Structure

7.09 Internal control structure policies and procedures relevant to loan funds normally affect the financial assistance program, which includes scholarships, fellowships, grants-in-aid, part-time employment, and special arrangements for payment of tuition and fees, as well as the loan program. The financial assistance program is the dual responsibility of academic and financial personnel. The academic representatives develop the broad policies of the financial assistance program. The administrator of financial aid is responsible for administering the program including review of applications, evaluation of need and qualifications of applicants, and amounts and kinds of aid appropriate in the circumstances. The financial officers of the institution are responsible for the custody and disbursement of funds for financial assistance, receipt and custody of the loan notes and the accounting for, reporting, and collection of the loans. The financial officers also have the obligation to inform the student aid administrator concerning the restrictions and limitations which may exist on the use of any of the funds and to monitor their observance. The usual segregation of duties between the disbursing of funds and the recording of receivables and custody of assets are equally applicable to loan fund administration.

Audit Procedures

7.10 The audit program for auditing cash, notes receivable, and investments of educational institutions will include the tests appropriate to many other kinds of organizations. Auditing the loans may include test examination of the notes, confirmation of selected balances, review of loan and collection procedures, tests of computations of interest income, and balancing of details with control accounts. Additional procedures and tests for loan funds which may be appropriate include the following:

1. A test of compliance with special terms and conditions found in restricted loan funds, such as loans limited to students originating from particular geographical areas, loans limited to students pursuing particular courses of study, government loan funds, and so forth.
2. A test of records documenting authorization for forgiveness of repayment of all or a portion of the amount due.
3. A review of conformity with requirements covering refunds of loan funds, transfers to other funds, and interest on loans.
4. A general review of procedures for maintaining records of names, changes of address, and other data with respect to loans receivable.

7.11 The independent auditor also may wish to make inquiries concerning the following items with respect to the financial aid program in general as well as the loan program:

1. Has the student financial aid committee established appropriate policies, standards, and requirements for administering the aid program?
2. Is the financial aid program sufficiently publicized and available to prospective borrowers and other grantees of aid in terms of general rules and regulations, qualifications of applicants, type of aid and resources available, repayment terms, interest, and so forth?
3. Are loans and other aid granted in accordance with the policies, general rules, regulations, and so forth?
4. Are the financial transactions of the funds sufficiently segregated from the financial aid administration?

5. Does the usual segregation of duties in the business office provide adequate safeguards over the collection and disbursement of funds for financial aid and for loans?
6. Does the acknowledgment procedure, internal reporting program, and recording in appropriate minutes provide reasonable safeguards over the receipt of new loan funds or additions to existing funds?
7. Does the business office follow an approved collection and follow-up policy and is the control over loans previously written off adequate?

Chapter 8

Endowment and Similar Funds

8.01 The endowment and similar funds group generally includes endowment funds, term endowment funds, and quasi-endowment funds.

8.02 Endowment funds are funds with respect to which donors or other outside agencies have stipulated, as a condition of the gift instrument, that the principal is to be maintained inviolate and in perpetuity and invested for the purpose of producing present and future income which may either be expended or added to principal.

8.03 Term endowment funds are similar to endowment funds except that, upon the passage of a stated period of time or the happening of a particular event, all or a part of the principal may be expended.

8.04 Quasi-endowment funds (funds functioning as endowment) are funds which the governing board of an institution, rather than a donor or other outside agency, has determined are to be retained and invested. Since these funds are internally designated rather than externally restricted, the governing board has the right to decide at any time to expend the principal.

8.05 Quasi-endowment funds are usually set aside to fulfill the same purpose as endowment funds and, therefore, should be accounted for in the same manner as endowment and term endowment funds. The only significant difference between endowment and quasi-endowment funds is that endowment fund principal is required by the donors or other outside agencies to be retained for the production of income to help meet present and future costs whereas the principal of quasi-endowment funds is retained and invested voluntarily, for the same or similar purposes. In the case of endowment funds the need to maintain the principal or corpus intact is mandatory.

8.06 Annuity and life income funds, if insignificant in amount, may also be included in this group. If significant, these funds should be reported in a separate fund group. The caption "Endowment and Similar Funds" should be used where endowment, term endowment, quasi-endowment, annuity, and/or life income funds are combined or grouped.

8.07 Each endowment and similar fund is accounted for in a separate fund. Each fund will include its own accounts for cash and investments unless the investments are pooled with the investments of other funds. Funds must, of course, be separately invested if the gift instrument so provides. Investments must also be made in accordance with the provisions of the gift instrument if restricted, for example, to investments which are legal for trust funds. It might be permissible under some circumstances to maintain a separate pool for funds required to be invested in securities approved for investment of trust funds. Some funds own both pooled and nonpooled investments; therefore, practical as well as legal considerations determine the accounting for each fund's principal account, its investments, and its income in accordance with the particular purpose to which the income is to be devoted. As indicated in SOP 74-8 [Appendix A], income yield from investments of endowment and similar funds does not include gains and losses on investment transactions, which are considered as changes in the balances of such funds.

Total Return Concept

8.08 Traditionally, educational institutions have accounted for income yield, dividends, interest, rents, royalties, and the like, as revenues available for institutional purposes and have excluded from that category capital gains on investment transactions. Net gains and losses have either been accumulated in a pool in the endowment and similar fund group or distributed periodically to the principal of the individual funds. The majority of educational institutions still follow this practice not only with respect to true endowment funds but all endowment funds, including quasi. This practice is rooted in the traditional legal precedents that, as recipients of gifts and bequests, educational institutions have functioned as charitable trustees when gifts are accepted for administration in contrast to absolute owners of the endowment gifts. Under classical trust doctrines, gains of endowment funds can only be added to principal and not be expended. The accounting for gains as principal is sometimes referred to as the fiduciary accounting principle.

8.09 Beginning with publication in 1969 by the Ford Foundation of *The Law and the Lore of Endowment Funds,* considerable support has been generated for a sharply contrasting view that there is no authoritative support in the law that gains are akin to principal and, therefore, cannot be spent. Advocates of this legal view hold that the trust law is inapplicable to endowment funds and that the corporate law concept is more applicable where the issues involved are administrative in nature, such as endowment investment management and allocation of gains to income or principal. The corporate law concept views the institution as the absolute owner of gifts with the obligation to include gains as income. Under the corporate law concept the income beneficiary and remainderman are usually the same whereas trust law demands a fair division between the income beneficiary and the remainderman (two distinct and sometimes antagonistic interests); gains traditionally have been kept for the remainderman.

8.10 Some institutions, with the advice of their legal counsel, have adopted what is usually referred to as a "total return" approach to endowment fund investment management. This approach emphasizes total investment return—traditional yield plus or minus gains and losses. Some users of a total return approach account for the portion of gain utilized for general operating purposes as revenue instead of as a transfer. Practically all total return approaches emphasize the use of "prudence" and a "rational and systematic formula" in determining the portion of gains which may be appropriated for expenditures and call for the protection of endowment principal from the loss of purchasing power (inflation) as a primary consideration before appropriating gains. Some approaches embrace spreading (deferral and amortization) techniques to eliminate extreme short-term fluctuations in realized gains and losses which often occur as mere accidents of timing under the completed transaction method. Others would combine realized and unrealized gains in a spreading approach. Most total return approaches have been confined to appropriating only gains of quasi-endowment funds whereas some institutions have appropriated gains of virtually all such funds including true endowment. Some approaches restrict the gains available for appropriation to only realized gains whereas others have considered unrealized gains as available for appropriation also.

8.11 In 1972 the National Conference of Commissioners on Uniform State Laws drafted the Uniform Management of Institutional Funds Act as a proposed clarification of the restrictions on trustees' and managers' powers to invest for growth. Among other things, it provides for a standard of prudent use of the excess of realized *and* unrealized appreciation of invested funds over the historic dollar value of the fund. The standard encompasses price level trends and economic conditions.

8.12 Several states have enacted legislation since the late 1960s dealing with the gain utilization question. The new statutes are not consistent as to whether both realized and unrealized gains may be used, the degree to which principal should be protected, or retroactivity of application. One statute *specifies* that the historic dollar value of the fund should be adjusted from time to time to reflect the change in purchasing power of that historic dollar value before appropriating any gains. None of the statutes specifically discusses gain-spreading or related techniques. In some jurisdictions, appropriation of gains may be limited or prohibited by applicable statutory or common law.

8.13 The law and the legal profession, while by no means in accord on the subject, appear to be heading in the direction of elimination of limitations on the governing board's right to appropriate gains for expenditure. The total return concept continues, however, to cause accountants difficulty in that the concept thus far has produced few, if any, practical applications which appear to be *objectively determinable.* No clear *redefinition* of traditional income yield has evolved. The exercise of prudence is subjective and not susceptible to measurement in an accounting sense. The practical applications of the total return concept utilized to date amount substantively to the selection of a "spending rate" usually relating the rate to the market value of the portfolio. They appear in some cases to involve an intolerable element of arbitrariness. Consequently, until a general practice evolves which is *objectively determinable,* the guide would do a disservice to higher education and the accounting profession to sanction as a permissible accounting treatment the inclusion in revenue of gains utilized under a total return approach. Therefore, any portion of gains utilized should be reported in the financial statements as a transfer. To the extent such a transfer is added to current funds, it should be reported separately from traditional income yield of endowment and similar funds and should not be included in total current funds revenues. If gains utilized are treated as revenue or income, the auditor should qualify his opinion. The fact that this guide does not sanction recognition of appropriated gains as revenues should not inhibit the application of the total return policy of investment management, a policy which has economic merit.

8.14 Considerable thought has been given to a total return approach that would be *objectively determinable.* An objectively determinable method would comprehend the following:

1. Inclusion in total return of all ordinary yield and all realized and unrealized net gains, to the extent legally permitted, less
    a. Allowance for spreading of extraordinary market fluctuations over a reasonable period of time, and
    b. Allowance for adjustment of historical dollar value of fund principal for price level changes.
2. Reporting all of the remainder as additions to the funds to which the income is restricted, and if unrestricted, as revenues of unrestricted current funds.
3. Application of this method to all endowment and similar funds, whether or not investments are pooled.
4. Utilization of generally accepted objectively determinable measures for
    a. Market or fair value of investments,
    b. Time period for spreading extraordinary market fluctuations, and
    c. Index for price level changes.

5. Utilization of this method by all institutions adopting the total return concept.
6. Application of this method on a consistent basis.

8.15 Transfers of investments between funds require that consideration be given to the market or appraised value of the securities because any change in value up to the date of the transfer should accrue or be charged to the owning fund for the holding period. As noted above, some transfers may involve legal considerations which require legal advice or court approval before consummation, depending on the terms of the gift instruments giving rise to the endowment.

8.16 Assets of endowment and similar funds usually consist of cash and investments but may also include accounts receivable, prepaid items, and the like. Investments may consist of marketable securities, nonmarketable securities, real estate, patents, copyrights, royalties, participations, etc., or evidences of indebtedness with respect to institutional plant. Investments are accounted for in accordance with the procedures explained in chapter 2.

8.17 Liabilities of endowment and similar funds consist of any form of indebtedness against assets representing investments of endowment real estate, balances due on purchases of investments, and interfund indebtedness arising from interfund transactions.

8.18 Income from endowment and similar funds should be reported in conformance with any limitations on the use of such income. Income from investments should be reported as either for

1. Restricted purposes, credited to the respective unexpended endowment income accounts in current restricted funds, or to fund balances such as endowment, plant, or loan, as specified by the terms of the endowment gift, or
2. Unrestricted purposes, credited to unrestricted current funds revenues.

8.19 Changes in principal of endowment and similar funds are comprised of additional gifts and bequests restricted to endowment, income added to principal as provided in the gift instrument, net gains or losses on investment transactions, transfers to quasi-endowment from other funds, and withdrawals or transfers to other funds. Fund-raising expenses should not be charged to the principal of endowment and similar funds unless they directly relate to the proceeds of a campaign for this purpose.

8.20 Upon termination, the unrestricted principal of term endowment funds should be added to unrestricted current funds revenues and clearly identified or disclosed so that no inference is made that a *new* gift has been received. Such addition should be directly to a group other than unrestricted current funds if the gift instrument specifies such other disposition of the fund.

Internal Control Structure

8.21 Internal control structure policies and procedures relevant to endowment and similar funds include those generally applicable to investments of commercial entities. In addition, internal control structure policies and procedures peculiar to endowment and similar funds may include the following:

1. Segregation of similar funds in fund groups and maintenance of asset accounts for each fund or merged assets for groups of funds.
2. Maintenance of adequate information for each individual fund indicating nature of principal, restrictions on investment of principal or

use of income, termination, etc. This usually involves the maintenance by the institution of an up-to-date register of each endowment fund containing summary information about the donor, time and amount of gift, type of fund, any external or internal restrictions, and reference to formal acceptance by the institution, as well as individual files of correspondence with donors and their representatives and copies of all bequests and other documents pertinent to the administration of a gift.

3. Adequate internal reporting of new gifts and the status and changes in principal of all individual or merged funds.
4. Maintenance and periodic review of a record of contingent bequests.
5. Periodic review of basis of distribution of gains and losses to individual funds.

Audit Procedures

8.22 Audit inquiries and tests of assets and fund balances of endowment and similar funds which may be applicable include the following:

1. Review of summary of investments of all funds and performance of the usual audit tests of all investment, principal, and income and gain accounts simultaneously.
2. Review of basis of valuation, amortization of premiums and accumulation of discount policies, and changes in participation in pooled investments. Tests of additions to and deductions from the pool or pools. Tests of computations where unit or share method of accounting for pooled investments is utilized.
3. Consideration of necessity for a valuation allowance if quoted market values of investments are substantially less than cost and there appears to be a permanent impairment in value.
4. Determination that the titles of the fund groups adequately describe the nature of the accounts included therein and that all of the individual funds of a particular group have the same general characteristics.
5. Determination that disclosure is made in the classification of donor-restricted funds as contrasted with unrestricted funds designated by the governing board to serve as quasi-endowment funds.
6. Review of gift acknowledgment procedures and determination that restrictive covenants are being followed.
7. Review of distribution of investment income and tests of accuracy of credits to restricted funds.
8. Review of distribution to individual funds of gains and losses on disposal of investments.
9. Consideration of obtaining confirmation from legal counsel of the propriety of any disposition of realized or unrealized gains.

Chapter 9

Plant Funds

9.01 The plant funds group consists of (1) funds to be used for the acquisition of physical properties for institutional purposes but unexpended at the date of reporting; (2) funds set aside for the renewal and replacement of institutional properties; (3) funds set aside for debt service charges and for the retirement of indebtedness on institutional properties; and (4) funds expended for and thus invested in institutional properties.

9.02 Some institutions combine the assets and liabilities of the four subfund groups for reporting purposes; however, separate fund balances should be maintained. Resources restricted by donors or outside agencies for additions to plant should be recorded directly in the particular fund subgroup, generally unexpended plant funds.

9.03 When physical plant assets are sold or otherwise disposed of, the carrying value should be removed from the asset accounts and net investment in plant should be reduced accordingly. The proceeds may be used to liquidate liabilities, if any, against the property and the remainder added to unexpended plant funds. Such amounts added to unexpended plant funds may be restricted, depending on the source of the funds of the property disposed of, and the educational institution should consider obtaining a legal opinion in that regard. If the proceeds are unrestricted and will not be reinvested in plant, they may be transferred to unrestricted current funds. If unrestricted proceeds are kept in unexpended plant funds, they should be properly disclosed in the financial statements as being unrestricted.

9.04 Student fees specifically assessed for debt service or plant expansion in such a manner as to create an obligation equivalent to an externally imposed restriction should be reported as additions to the appropriate plant fund subgroup. Such a restriction could be created, for example, when an institution publicly represents that it will use certain fees only for the retirement of certain debt or for the construction of a particular building. If, on the other hand, the governing board retains the right at its discretion to use such fees for other purposes, such fees are not restricted and accordingly should be reported as unrestricted current funds revenue.

9.05 Indebtedness incurred to finance plant acquisition, construction, and the like, should be included as a liability of the unexpended plant funds subgroup until the proceeds of the indebtedness are expended, at which time the expended amount and the related liability should be transferred to the investment-in-plant subgroup.

9.06 Board-designated balances in each of the fund subgroups—except for investment in plant—as opposed to funds restricted by donors for plant fund purposes, should be disclosed. Income and gains, net of losses, on investments of both board-designated and donor-restricted plant funds should be added to the fund balance of the related subgroup.

9.07 Transfers from other fund groups to plant funds for the acquisition of physical properties, renewals and replacements, and debt service should be represented by the appropriate transfer of cash or other liquid assets. Temporary advances from other fund groups to plant funds should be made only upon authorization or approval of the governing board stipulating the terms of repayment. If it is determined that such advances cannot or will not be repaid by plant funds, the governing board should authorize the permanent transfer of the funds.

Unexpended Plant Funds

9.08 Assets of unexpended plant funds consist of cash, investments, accounts receivable, and amounts due from other funds.

9.09 Liabilities of unexpended plant funds may consist of accounts payable, bonds, notes, and mortgages payable, to the extent the proceeds are unexpended at the reporting date, and amounts due to other funds.

9.10 Fund balances of unexpended plant funds represent amounts remaining unexpended at the reporting date. Additions to unexpended plant fund balances include donations from private sources restricted to plant purposes; restricted appropriations of governmental agencies; income and gains from the investment of unexpended plant funds; and transfers from other fund groups including those from current funds. Deductions include disbursements for plant purposes; losses on investments of unexpended plant funds; return of unrestricted balances to unrestricted current funds; and other appropriate charges such as fund-raising expenses related to a building fund campaign.

9.11 Asset accounts and corresponding accountability may also be maintained in this subgroup for construction in progress during the period of construction, if not included in the investment-in-plant subgroup.

Funds for Renewals and Replacements

9.12 Assets of funds for renewals and replacements consist of cash, investments, funds on deposit with others, accounts receivable, and amounts due from other fund groups. Liabilities of these funds consist of accounts payable and amounts due to other fund groups for temporary advances.

9.13 Fund balances represent unexpended resources held for renewal and replacement of physical plant and should be subdivided between unrestricted resources designated by the governing board for these purposes and restricted resources including balances arising from agreements with outside agencies such as trustees under bond indentures, as well as restricted gifts, grants, governmental appropriations, and the like. An account or accounts are usually maintained for each specific project or indenture.

9.14 Additions to funds for renewals and replacements arise from mandatory and voluntary transfers from current funds and income and gains on investments of these funds. In some cases governmental appropriations and other gifts and grants are made specifically for these purposes and recorded as direct additions to the restricted portion of the fund balance. Deductions from the fund balance consist primarily of expenditures for renewals and replacements of plant, some of which may be considered as additions to plant assets in the investment-in-plant subgroup, and some may be renewals and replacements of a type not ordinarily capitalized. Other deductions might include losses on investments of these funds and transfers of funds back to unrestricted current funds.

Funds for Retirement of Indebtedness

9.15 Assets of funds for retirement of indebtedness consist of cash, investments, funds on deposit with others, accounts and notes receivable, and amounts due from other fund groups. Liabilities consist of sundry accounts payable for such items as trustees' fees.

9.16 Fund balances represent resources held for the retirement of and interest on debt and include sinking funds established under bond indentures, mortgage amortization payments accumulated but not yet due, and other resources accumulated for interest and debt retirement. Fund balances should be subdivided between unrestricted resources designated by the governing board for these purposes and restricted resources including balances arising from agreements with outside agencies such as trustees under bond indentures, as well as restricted gifts, grants, governmental appropriations, and the like which are recorded or direct additions to the restricted portion of the fund balance. Separate accounts are ordinarily maintained for each debt.

9.17 Additions to fund balances of funds for retirement of indebtedness include mandatory and voluntary transfers from current funds for interest and principal payments; income and gains on investments of these funds; gifts, grants, and governmental appropriations restricted to debt retirement; and transfers from other fund groups as directed by donors, such as expired term endowment, annuity, or life income funds. Deductions from fund balances include payments on principal of debt and interest thereon, trustees' fees and expenses, and any losses on investments of these funds.

Investment in Plant

9.18 Assets of the investment-in-plant subgroup consist of land, buildings, improvements other than buildings, and equipment (including library books). Construction in progress may be included in this subgroup if it is not included in unexpended plant funds.

9.19 The basis of valuation for assets purchased or constructed is cost; for assets acquired by gift, it is fair market value at the date of gift. In the absence of historical cost records, the assets may be stated at historically based appraised values with subsequent additions at cost. The basis of valuation should be adequately disclosed in the financial statements, by footnote or other means. Library books should be valued at cost or some other reasonable basis. For discussion of depreciation see chapter 2.

9.20 Liabilities consist of accounts payable and evidences of indebtedness such as bonds, notes, and mortgages payable for funds borrowed and expended for acquisition or construction of plant assets included in this fund subgroup.

9.21 The net investment in plant is the fund balance account representing the excess of investment-in-plant assets over liabilities. Additions to this fund balance account arise from capital expenditures of unexpended plant funds and funds for renewals and replacements; from reduction of indebtedness made by funds for retirement of indebtedness; from expenditures from current funds for replacement of equipment; and from gifts of plant assets, including equipment, art and other collections, and books. Reductions in the fund balance account result from the recording of disposal, abandonment, or sale of plant assets.

Internal Control Structure

9.22 Internal control structure policies and procedures relevant to transactions in plant funds will be aided by the maintenance of the four subgroups mentioned in this chapter. Features of an internal control structure relevant to plant funds may include the following:

1. Control by the governing board over capital budgets and changes therein.
2. Recording of commitments and appropriations as well as expenditures in control or project accounts as part of the regular system of accounting.
3. Maintenance of plant ledgers.
4. Periodic internal physical inventory of moveable equipment.

5. Custodial control of both fixed and moveable equipment and control of interdepartmental movements.
6. Procedures for control over disposals and salvage.
7. Maintenance of records of property in the custody of, but not owned by, the institution.
8. Authorization and documentation procedures for creation of long-term debt, including records of assets or revenue pledged, sinking funds, or installment payments required.
9. Records documenting building fund campaigns including records of restricted or special gifts.
10. Receiving and acknowledgment procedures for gifts of fixed assets.
11. Procedures for provisions and transfers from unrestricted current funds based on requirements for renewals, replacements, and retirement of indebtedness.

Audit Procedures

9.23 Audit tests of plant funds generally should include the procedures appropriate for commercial entities. Audit procedures peculiar to educational institutions may include the following:

1. Examination of provisions of gifts and bequests for plant purposes.
2. The review and testing, by reference to appropriate documents, of the validity of capitalizing expenditures of current funds representing equipment purchased by such funds. Determination that title to the equipment so acquired is vested in the institution.
3. The review and testing of transactions of building fund-raising campaigns.
4. Review of procedures relating to the receipt of gifts in kind, including methods used in valuing such gifts.
5. Review of provisions of long-term debt agreements and observation that requirements have been met, including the nature and extent of pledging of assets and revenues and approval by governing board.
6. Examination on a test basis of documents supporting other changes in fund balances.

Chapter 10

Other Fund Groups

ANNUITY FUNDS

10.01 The annuity funds group consists of funds acquired by an institution subject to agreements whereby assets are made available to the institution on the condition that the institution bind itself to pay stipulated amounts periodically to designated individuals. Payments of such amounts terminate at a time specified in the agreements.

10.02 In many jurisdictions the "selling" or acceptance of annuities by a nonprofit organization is subject to the regulations of the appropriate governmental department or agency. Annuities can be issued only under regulations promulgated by the agency and, in some instances, investments of the annuity funds must be deposited or a security deposit made with the governmental jurisdiction. The supervising agency may also designate the types of investments which may be made from these funds.

10.03 Upon termination, the principal of annuity funds is transferred to the fund group designated by the grantor or, in the absence of such a designation, to unrestricted current funds revenue and accorded the same treatment as unrestricted expired term endowments.

10.04 There are two methods of recording and reporting annuity funds, only one of which is included in the Manual. The actuarial method requires the recording of the assets at cost or at fair market value at date of receipt. The liability side includes an account for the present value of the aggregate liability for annuities payable, based upon acceptable life expectancy tables, and an account for the fund balance or deficit. When a gift is received, the present value of the annuities payable is credited to the liability account and the remainder to the fund balance. Investment income and gains are credited, and annuity payments and investment losses are charged, to the liability account. Periodically, an adjustment is made between the liability and the fund balance to record the actuarial gain or loss due to recomputation of the liability based upon the revised life expectancy. By recognizing the present value of the annuities as a liability, the actuarial method meets the requirements of generally accepted accounting principles and therefore should be used.

10.05 The method explained in the Manual provides for the recording of the assets at cost or at fair market value at date of receipt with the resulting credit to the annuity fund balance. Income and gains are credited, and losses charged, to the fund balance. Annuity payments are charged to the fund balance.

10.06 Because the method explained in the Manual does not recognize as a liability the present value of the annuities, it is in conflict with generally accepted accounting principles, and therefore should not be used.

10.07 The assets of annuity funds include cash, securities, and other types of investments, the valuation of which is determined and reported in a manner comparable to that for investments of endowment and similar funds. Assets are sometimes merged for investment purposes depending upon the frequency of adjustments of shares owned by individual funds, the actual number of funds, and the regulations of supervisory authorities.

10.08 The liabilities of annuity funds include indebtedness against any of the assets of the funds, annuity payments currently due, amounts due to other funds for advances made on annuity payments, and the actuarial amount of annuities payable.

10.09 Increases in annuity fund balances consist of additions of new gifts in excess of actuarial liability for annuities payable. Decreases include transfers to other funds upon termination of annuity funds. Additional changes in the fund balances occur when an adjustment is made between the liability and the fund balance, representing changes due to revised life expectancy.

10.10 The basic statement of changes in annuity fund balances is usually combined with the changes in life income funds.

Internal Control Structure and Audit Procedures

10.11 Internal control structure policies and procedures and audit procedures that may be applicable to annuity funds do not differ materially from those applicable to endowment funds described in chapter 8. The annuity liability and fund balance amounts should be tested by reference to life expectancy and interest tables.

LIFE INCOME FUNDS

10.12 The life income funds group consists of funds contributed to an institution subject to the requirement that the institution periodically pay the income earned on the assets to designated beneficiaries. Such payments terminate at a time specified in the agreements, usually upon death of a designated individual. In order to qualify for and maintain a tax-exempt status for pooled life income funds, it is extremely important that the institution acting as trustee be thoroughly conversant with the tax laws governing the formation and operation of life income funds.

10.13 Life income funds are usually accounted for as a separate fund group but are combined for reporting purposes with annuity funds. When amounts are not material, both of these fund groups may be reported as a subclassification of endowment and similar funds. The transactions of life income funds should be reported separately and not as current funds revenues or expenditures. A separate set of accounts must be maintained for each life income fund. Upon termination, the balance of the fund is transferred to the fund group designated by the grantor or, in the absence of a designation, to unrestricted current funds and accorded the same treatment as unrestricted expired term endowments.

10.14 The assets of life income funds include cash, securities, and other types of investments, the valuation of which is determined and reported in a manner comparable to that for investments of endowment and similar funds. Assets of life income funds may be separately invested, pooled with other life income fund assets, or pooled with assets of annuity funds and/or endowment and similar funds.

10.15 The liabilities of life income funds include indebtedness against the assets, life income payments currently due, and amounts due other funds for advances made to income beneficiaries.

10.16 Changes in life income fund balances consist of additions of new gifts, gains and losses on investments, and transfers to other funds upon termination of the agreements.

10.17 The financial statement presentation of life income funds is similar to the presentation of, and sometimes combined with, annuity funds.

Internal Control Structure and Audit Procedures

10.18 Internal control structure policies and procedures and audit procedures that may be applicable to life income funds conform generally to those appropriate for endowment funds discussed in Chapter 8.

AGENCY FUNDS

10.19 The agency funds group consists of funds held by an institution as custodian or fiscal agent for others such as student organizations, individual students, or faculty members. Agency funds should be accounted for as a separate fund group although, if immaterial in amount, they may be reported as assets and liabilities of current funds. Transactions of agency funds represent charges or credits to the individual asset and liability accounts and are not transactions of unrestricted or restricted current funds.

10.20 Assets of agency funds include cash, investments, and sometimes accounts receivable or interfund receivables. Liabilities of agency funds include accounts payable to third parties, interfund payables, and balances representing the net assets owing to the individual or organization for which the institution is acting as custodian.

10.21 Accountability for agency funds usually requires the submission of periodic reports of transactions and balances to the individual or organization that owns the net assets. It is adequate to report in the basic financial statements only the assets and liabilities by major type and the net assets held as deposits in custody for others.

10.22 The Manual suggests that a statement of changes in fund balances be submitted showing total balances at the beginning, total additions, total deductions, and total balances at the end of the reporting period. While this statement would give some indication of the magnitude of the transactions, the balances are liabilities and, therefore, this statement should not be considered a basic financial statement. In most cases its presentation is questionable and therefore it should be omitted.

Internal Control Structure

10.23 Internal control structure policies and procedures relevant to agency funds are similar to those over cash, investments, and other assets of the institution. Control is improved by the segregation of such funds in a separate fund group for accounting and reporting purposes. Internal control is exercised by requiring the approval of transactions by the owning individual or organization. In the case of student organizations, additional review may be exercised by a faculty advisor or administrator.

Audit Procedures

10.24 Audit procedures applicable to agency fund assets are comparable to procedures performed with respect to similar assets of other fund groups. Audit procedures applicable to liabilities consist primarily of a test of the transactions, including a review of documentation and confirmation on a test basis with the owning individuals or organizations.

OTHER FUNDS

10.25 The accounting, reporting, and auditing of other fund groups administered by the institution—such as pension funds—are comparable with the procedures for endowment and/or agency funds, and in some instances are comparable with those of commercial pension funds. A review of internal control must be performed in order to tailor the audit procedures to the needs of the particular engagement with respect to these special funds.

Chapter 11

Financial Reports

11.01 Financial reporting for educational institutions should generally include three basic types of financial statements, namely (a) balance sheet, (b) statement of changes in fund balances, and (c) statement of current funds revenues, expenditures, and other changes.

11.02 Accounting Principles Board (APB) Opinion No. 19* refers to the use by all profit-oriented entities of a statement of changes in financial position as a basic financial statement. The statement of changes in fund balances sets forth essentially the same information included in a statement of changes in financial position. Where significant resources or expenditures such as financing activities and investments in plant are not included in the statement of changes in fund balances, such activities may be separately disclosed in a note or elsewhere in the financial statements.

11.03 The statement of current funds revenues, expenditures, and other changes is a statement unique to educational and similar institutions. It is a statement of financial activities of current funds related to the current reporting period showing the details of current funds revenues by source, current funds expenditures by function, and all other changes in current funds. See SOP 74-8 [Appendix A] for definitions and descriptions of revenue sources and expenditure functions, respectively. It does not purport to present the results of operations or the net income or loss for the period as would a statement of income or a statement of revenues and expenses. The net increases or decreases reported on this statement should be the same as the amounts reported as net changes in unrestricted and restricted current funds in the statement of changes in fund balances.

11.04 The statement of current funds revenues, expenditures, and other changes is intended to achieve certain reporting objectives, namely the following:

1. To provide the reader with adequate information concerning the details of the sources and uses of current funds,
2. To enable the institution to report the total of unrestricted and restricted current funds expended for each of the functional categories so that the total level of financial activity for each such function is disclosed, and
3. To facilitate the presentation of a comparison with prior years if desired.

11.05 These objectives may be achieved in other ways. For example, the statement of changes in fund balances may be expanded to show the unrestricted revenues by source, rather than in summary totals only, and a third statement may be used to report the details of expenditures by function. In so doing, however, it should be remembered that revenues arising from the use of restricted funds are not normally the equivalent of restricted current fund additions. Therefore, the amounts earned through the use or expenditure of

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* [Note—APB Opinion No. 19 has been superseded by FASB Statement No. 95, *Statement of Cash Flows.* Not-for-profit entities are excluded from the scope of FASB Statement No. 95. GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Funds and Governmental Entities That Use Proprietary Fund Accounting,* superseded APB Opinion No. 19 for state and local governmental units. Governmental colleges and universities that adopt the AICPA College Guide Model are exempt from the requirement to present a statement of cash flows.]

such funds should also be disclosed in these basic statements or in the notes thereto.

11.06 Variations in format and presentation also may be desirable in instances where institutional management requirements or practices would be more readily communicated to the reader through such reporting devices. For example, institutions which manage unrestricted gifts as separate resources may prefer to add additional columns in the statement of changes in fund balances and the statement of current funds revenues, expenditures, and other changes in which such gifts received or transferred, and balances at the beginning and end of the reporting period, could be separately disclosed. Similarly, the revenues, expenditures, transfers, assets, liabilities, and fund balances of current funds allocated to auxiliary enterprises, hospitals, or other special activities may be set forth in separate columns as fund subgroups. In all such cases, however, the statements should clearly indicate the unrestricted nature of such funds and related changes for the period. In addition, a total column for all unrestricted current funds revenues, expenditures, and other changes for the period should be included in the appropriate statements.

11.07 The financial statements in SOP 74-8 [Appendix A], thus, are guidelines illustrating the accounting principles and reporting practices embodied throughout this guide. They are not intended to represent the only forms since the requirements of fairness and objectivity are always paramount for both the institution and the independent auditor.

11.08 The balance sheet may be presented with funds arranged sequentially in vertical order as illustrated, or it may be presented in columnar form with a column for each major fund group. Changes in fund balances may be presented in columnar fashion in a single statement as illustrated or in separate statements for each major fund group. Special considerations relating to the use of a columnar statement are the following:

1. In the balance sheet, columnar fund group figures should not be cross-footed in a total column, to reflect an overall financial picture of the institution, unless all necessary disclosures are made, including interfund borrowings.
2. In the statement of changes in fund balances, columns should not be cross-footed unless care is taken to avoid the mislabeling of cross-footed totals and duplication of gross changes.
3. Balances of any fund subgroups necessary for fair presentation, particularly those subgroups segregating donor-restricted from board-designated resources, must be disclosed either in the balance sheet or in the statement of changes in fund balances.

11.09 For adequate disclosure, all separately incorporated but related units for which the reporting institution is fiscally responsible, such as university presses, intercollegiate athletics, and research foundations, should be (1) included in the financial statements, (2) adequately disclosed by notes, or (3) presented in separate financial statements accompanied by and cross-referenced in the basic financial statements of the institution.

11.10 The basic financial statements may be accompanied by supplemental schedules setting forth in greater detail the data included in the basic statements. One such schedule which may be particularly useful to institutions employing the total return concept and/or managing unrestricted gifts as separate resources would be a schedule of current funds expenditures and resources utilized. Such a schedule could relate the total of current funds expenditures and mandatory provisions to the current funds resources which were utilized in meeting these needs. The totals of both sections of the schedule—expenditures plus mandatory provisions and resources utilized—would be equal. Other schedules which might prove to be useful and informative may be the following:

- Summary of gifts received by source and purpose
- Schedule of current funds revenues
- Schedule of current funds expenditures
- Schedules of auxiliary enterprise operations
- Summary of investments
- Summary of property, plant, and equipment
- Schedule of long-term debt
- Details of fund balances and changes therein during the period in each fund within each fund subgroup

Reporting Accounting Changes

11.11 Adjustments resulting from a change in accounting method to comply with recommendations in this audit guide should be treated as adjustments of prior periods, and financial statements presented for the periods affected should be restated appropriately. For guidelines in reporting upon the financial statements that have been restated, the independent auditor should refer to Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements,* paragraph 36. For any accounting changes subsequent to those required for conforming with this audit guide, the Committee reaffirms the applicability of APB Opinion No. 20, which defines various types of accounting changes and establishes guides for determining the manner of reporting each type.

11.12 APB Opinion No. 20 deals with the reporting of changes in accounting principles and estimates, changes in the reporting entity, and the correction of an error in previously issued financial statements. However, if an industry audit guide prepared by a committee of the American Institute of Certified Public Accountants prescribes the manner of reporting such changes, the provisions of the Opinion do not apply. This audit guide prescribes that the provisions of APB Opinion No. 20 apply to the statements of colleges and universities except for those provisions which relate to the presentation of results of operations for business organizations (and, therefore, have no counterpart in statements of colleges and universities) such as:

1. Inclusion, in the net income of the period of change, of the prior year cumulative effect on retained earnings of changing to a new accounting principle.
2. Disclosure of pro forma net income and per share data on the face of the income statement.

11.13 In most cases, as applied to educational institutions, the reporting of a change in accounting principles would be as follows:

1. The financial statements for prior periods would be presented as previously reported,
2. The effect of the change on the current and prior periods shown would be disclosed in the financial statements or in the notes to the statements, and
3. The cumulative effect of the change would be shown in the statement of changes in fund balances.

Illustrative Financial Statements

[**11.14—11.19**] [Superseded by SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*. See Appendix A.]

Chapter 12

Reports of Independent Auditors

12.01 The opinions of independent auditors are expressed on the basic financial statements of the institution as a whole. In addition, opinions of independent auditors may be required with respect to special financial reports covering individual funds or activities. The independent auditor should refer to SAS No. 62, *Special Reports,* for a discussion of the general requirements respecting special reports.

Form of Reports

12.02 The standard report format has heretofore been used frequently by independent auditors in reporting on the basic financial statements of educational institutions. This report refers to "results of operations" commonly deemed to embody changes in net worth as well as in revenues, expenses, and net income for the period.

12.03 As described in chapter 11, the statement of current funds revenues, expenditures, and other changes does not purport to present the results of operations or the net income for the period of the institution as a whole, as would an income statement or a statement of revenues and expenses. For example, the statement of current funds revenues, expenditures, and other changes does not include a provision for depreciation. On the other hand, it does include charges for capital outlay, such as mandatory provisions for payment of principal of indebtedness, mandatory provisions for renewals and replacements of equipment, and expenditures from current funds for renewals and replacements of equipment.

12.04 As a result of the nature of the statements described above, the independent auditor's opinion should use wording more descriptive of the information in the statements rather than "results of operations." An example of such wording is "changes in fund balances and current funds revenues, expenditures, and other changes."

12.05 An example of the independent auditor's report follows.

Independent Auditor's Report

The Board of Trustees
Sample Educational Institution:

We have audited the accompanying balance sheet of Sample Educational Institution as of June 30, 19__ and the related statements of changes in fund balances and current funds revenues, expenditures, and other changes for the year then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Sample Educational Institution as of June 30, 19__, and the changes in fund balances and the current funds revenues, expenditures, and other changes for the year then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

12.06 Where the basic financial statements are accompanied by supplemental schedules, the extent of the independent auditor's responsibility should be indicated.

12.07 For information on auditing federally funded student financial assistance programs, refer to the U.S. Department of Education Audit Guide, *Audits of Student Financial Assistance Programs.* Copies of the Guide can be obtained from:

U.S. Department of Education
Office of Inspector General
330 C Street SW
Washington, DC 20202

Appendix A

Statement of Position 74-8

FINANCIAL ACCOUNTING AND REPORTING BY COLLEGES AND UNIVERSITIES

August 31, 1974

Issued by Accounting Standards Division
American Institute of Certified Public Accountants

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances. However, an entity need not change an accounting treatment followed as of March 15, 1992 to the accounting treatment specified in this Statement of Position.

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York
10036 (212) 575-6200

August 31, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

Proposal to Amend the
AICPA Industry Audit Guide
on Audits of Colleges and
Universities

Two recent publications on college and university financial accounting and reporting have endorsed expansion, clarification, and revision of the AICPA Industry Audit Guide on *Audits of Colleges and Universities* (Audit Guide) in certain respects. The new publications are *College and University Business Administration—Administrative Service*, published in May 1974 by the National Association of College and University Business Officers, and *Report of the Joint Accounting Group*, published in March 1974 by the Western Interstate Commission for Higher Education.

Members of the AICPA Accounting Standards Task Force on Colleges and Universities participated in a consultative capacity in the development of both publications and the Task Force has prepared the accompanying Statement of Position. Its purpose is to bring to your attention amendments to the Audit Guide recommended by the Task Force to conform the guide to the new publications and to request that the profession be advised, by whatever means seem appropriate, whether FASB concurs with the proposed amendments.

The amendments would give effect to the revenue, expenditure, and transfer descriptions and classifications set forth in Part 5 of the Administrative Service. They would be consistent with recommendations in those respects in the *Report of the Joint Accounting Group*.

Issuance of this Statement of Position will help to apprise independent auditors and others who are interested in college and university accounting and financial reporting matters of the existence of the two new publications and of the recommendation of the Task Force as to the appropriate corresponding amendment of the Audit Guide. We urge, however, as a further and more conclusive step that FASB advise the accounting profession at an early date as to whether it believes the proposed amendments are appropriate and should be regarded as having the same authoritative support as if they had been included in the Audit Guide initially. A prompt indication to the profession is especially desirable in view of the extensive recent distribution of the two aforementioned publications and in anticipation that some institutions may want to adopt the revised classifications in their fiscal 1974 financial statements.

Members of the Task Force will be glad to meet with you or your representatives to discuss these proposals. It would appreciate being advised as to the Board's proposed action on its recommendations.

Sincerely yours,

ACCOUNTING STANDARDS TASK FORCE
ON COLLEGES AND UNIVERSITIES

Jay H. Anderson, Chairman
Delford W. Edens
Daniel D. Robinson
Russel F. Viehweg

Audits of Colleges and Universities

Background Information

At the time of final editing of the Industry Audit Guide on *Audits of Colleges and Universities* (Audit Guide) in June 1973, the Committee of AICPA members which prepared the Audit Guide was aware of discussions then in progress among members of the Accounting Principles Committee of the National Association of College and University Business Officers (NACUBO) and the National Center for Higher Education Management Systems (NCHEMS) concerning the classification of revenues and expenditures in higher education financial accounting and reporting. The Preface of the Audit Guide mentions that the guide was developed with the coordination and cooperation of representatives of NACUBO.

The fundamental accounting principle relating to presentation of revenues and expenditures which was adopted by the Audit Guide Committee was that *revenues should be classified by source and expenditures by function.* The Committee felt that, as long as this basic classification philosophy was adhered to, any reasonable amount of detail of revenues, expenditures, and transfers desired by the industry would be agreeable to the accounting profession. The detailed categories of revenues, expenditures, and transfers shown in the Audit Guide reflected the most recent recommendations of NACUBO at that time and deviated somewhat from those displayed in the 1968 revised edition of *College and University Business Administration,* or *CUBA* (1968). CUBA (1968) was published by the American Council on Education and, until publication of the Audit Guide by the AICPA in August 1973 and Part 5 of *College and University Administration—Administrative Service* (Administrative Service) by NACUBO in May 1974, was regarded as the major authoritative pronouncement on college and university accounting and financial reporting.

Efforts were launched in the summer of 1969 by NACUBO to revise *CUBA* (1968). Efforts were under way at NCHEMS to prepare a Higher Education Finance Manual (HEFM), a project sponsored by the U.S. Office of Education to provide, among other things, procedures and formats for reporting financial data needed for planning and management at the institutional as well as state and federal government levels. A meeting of representatives of each of three interested groups (NACUBO, NCHEMS, and AICPA) resulted in the concept of a joint effort to identify and clarify areas of difference and explore mutually satisfactory ways of developing more uniformity. The Chairman of the AICPA Committee which had developed the Audit Guide and two other members of that Committee, which officially dissolved in October 1973, were invited to become members, along with NACUBO and NCHEMS representatives, of a new Joint Accounting Group (JAG) to carry out these objectives.

JAG's work was completed with the publication by the Western Interstate Commission for Higher Education, Boulder, Colorado, in March 1974 of the *Report of the Joint Accounting Group.* The primary recommendation of that report was that, with the exception of current funds revenues, expenditures and transfers, higher education institutions should utilize the accounting definitions and practices outlined in the Audit Guide. The JAG report in Appendixes I and II set forth recommended revenue, expenditure, and transfer category descriptions which represented a revision of those presented in the Audit Guide. The JAG also recommended that its revised revenue, expenditure, and transfer categories be incorporated into the Audit Guide and the new

Administrative Service. The categories recommended by the JAG were later used by NACUBO in its preparation of Part 5 of the new Administrative Service. Thus, the report of the JAG was an initial step toward the inclusion of the revised revenue, expenditure, and transfer categories in the new Administrative Service which the Task Force now considers more current than those included in the Audit Guide.

The JAG was formed in the summer of 1973 and at the same time, at the request of officials of NACUBO, the Accounting Standards Division of the AICPA organized a Task Force, consisting of four of the members of the former Audit Guide Committee (including the three individuals participating with the JAG), to consult with NACUBO's Accounting Principles Committee regarding the revision of *CUBA* (1968). This revision was published as a section (Part 5) of the new looseleaf Administrative Service. It can be obtained by subscription from NACUBO, Suite 510, One Dupont Circle, Washington, D.C. 20036. The new Administrative Service replaces *CUBA* (1968) as the major authoritative pronouncement on college and university accounting and financial reporting published by the industry.

Both the NACUBO and JAG efforts were conducted in close coordination with each other and involved overlap of representatives of AICPA, NACUBO, and NCHEMS. Both of these projects involved a certain amount of refinement of revenue, expenditure, and transfer definitions and classifications. However, no deviations from the fundamental accounting principles, auditing procedures or standards of financial statement presentation from those set forth in the Audit Guide were advocated in the two publications. Neither of the publications deals at all with auditing standards. The participation of AICPA Committee and Task Force members in these two publication efforts was geared to provide the two primary constituencies (NACUBO and NCHEMS) with background information and explanations about the content of the Audit Guide and to assist them in making sure that their publications did not deviate from the basic accounting principles and standards of financial reporting contained in the Audit Guide. Even though the JAG report and the new Administrative Service reflect different literary styles, the Task Force members who were involved in the consulting projects believe that those publications do not contain any significant deviations from the accounting principles and reporting standards reflected in the Audit Guide. The Audit Guide concept of revenues by source and expenditures by function has been followed.

Recommendation

The Task Force believes that the descriptions and classifications of revenues, expenditures, and transfers, as they pertain to current funds, set forth in Chapters 5:2 (Current Funds), 5:6 (Chart of Accounts), and 5:7 (Illustrative Exhibits) of the new Administrative Service should be recognized by practitioners as representing more current descriptions and classifications than those presented in the Audit Guide and that, until such time as the Audit Guide is revised, independent auditors should refer to those parts of NACUBO's new Administrative Service, which are appended to this Statement of Position, in connection with current funds revenue, expenditure, and transfer account descriptions and classifications.

Specifically, the Task Force believes the Audit Guide should be considered as being superseded by the Administrative Service as follows:

a. Chapter 5.01-5.20, Current Funds Revenues, of the Audit Guide, through the section on Expired Term Endowments, should be superseded by the section Current Funds Revenues beginning on Page 2 of Chapter 5:2, Current Funds, of the Administrative Service.

b. Chapter 6.01-6.22, Current Funds Expenditures and Transfers, of the Audit Guide, through the section on Other Transfers —Unrestricted Current Funds, should be superseded by the section on Current Funds Expenditures and Transfers, beginning on Page 6 of Chapter 5:2, Current Funds, of the Administrative Service.

c. The Illustrative Financial Statements in Exhibits 11.14-11.16 of the Audit Guide should be superseded by Chapter 5:7, Illustrative Exhibits, of the Administrative Service.

d. The section of Chapter 5:6, Chart of Accounts, of the Administrative Service, beginning with Current Funds Revenues Accounts through the end of Page 10, should be added to the Audit Guide as Appendix A.

The Task Force further believes that adoption of the expanded descriptions and classifications should be effective for all fiscal years beginning after June 30, 1974.

Current Funds

The current funds group includes those economic resources of a college or university which are expendable for the purpose of performing the primary missions of the institution—instruction, research, and public service—and which are not restricted by external sources or designated by the governing board for other than operating purposes. The term "current" means that the resources will be expended in the near term and that they will be used for operating purposes.*

The Current Funds group has two basic subgroups—unrestricted and restricted. Unrestricted current funds include all funds received for which no stipulation was made by the donor or other external agency as to the purposes for which they should be expended. Restricted current funds are those available for financing operations but which are limited by donors and other external agencies to specific purposes, programs, departments, or schools. Externally imposed restrictions are to be contrasted with internal designations imposed by the governing board on unrestricted funds. Internal designations do not create restricted funds, inasmuch as the removal of the designation remains at the discretion of the governing board.

The distinction between unrestricted and restricted funds is maintained through the use of separately balanced groups of accounts in order to provide acceptable reporting of stewardship to donors and other external agencies. This distinction also emphasizes to governing boards and other sources of financial support the various kinds of resources of the Current Funds group that are available to meet the institution's objectives.

Separate accounting entities may be provided for auxiliary enterprises, hospitals, and independent operations in either the Unrestricted Current Funds or Restricted Current Funds subgroup or both, as appropriate.

Assets, Liabilities, and Fund Balances of Current Funds

Assets usually consist of cash, accounts receivable, including unbilled charges, notes receivable, undrawn appropriations, investments, amounts due from other fund groups, inventories, prepaid expenses, and deferred charges. "Unbilled charges" are those which have been earned but which, because of

* Reprinted from *College and University Business Administration*, second revised edition (1974), by permission of the National Association of College and University Business Officers.

inadequate information, incomplete projects or programs, or the timing of the billing cycle, have not been formally billed at the balance sheet date. "Undrawn appropriations" are those to which the institution is entitled, but which have not been remitted or made available to the institution by the appropriating federal, state, or local agency. "Deferred charges" are expenditures that are related to projects, programs, activities, or revenues of future fiscal periods.

Liabilities usually consist of accounts and notes payable, accrued liabilities, deposits, amounts due to other fund groups, and deferred credits. Accrued liabilities include such items as interest, wages, salaries, and taxes. Deferred credits are those revenues of unrestricted current funds that are applicable to a future period, when they become earned.

The individual assets and liabilities, but not the fund balances, of unrestricted and restricted current funds are sometimes combined for reporting purposes, but, if they are combined, the borrowings between unrestricted and restricted funds should be disclosed by footnote or other appropriate means.

The fund balances may be subdivided to show allocations applicable to auxiliary enterprises, hospitals, independent operations, outstanding encumbrances, other allocations by operating management or by the governing board, budget balances brought forward from prior fiscal periods, and the unallocated balance.

Changes in the balances of unrestricted current funds include the gross amount of all unrestricted revenues and expenditures applicable to the reporting period, as determined in accordance with the accrual basis of accounting, and transfers to and from other fund groups for the period. Significant allocations of unrestricted current fund balances should be disclosed.

The fund balances of restricted current funds should be classified in the accounting system to show the various classes and sources of funds and purposes of restriction. Such restrictions often relate to the use of endowment fund income; gifts, grants, and contracts from private and governmental sources; and legislative appropriations. Further breakdowns may be provided to show amounts restricted to auxiliary enterprises, hospitals, and independent operations, if such activities are the beneficiaries of restricted current funds.

Additions to fund balances of restricted current funds arise from the sources indicated in the preceding paragraph. Deductions from restricted fund balances result from:

1. Direct expenditures and mandatory transfers.
2. Refunds to donors and other external agencies.
3. Amounts transferred to unrestricted revenues representing indirect cost recoveries on appropriate programs.
4. Nonmandatory transfers.

Current Funds Revenues

Current funds revenues include (1) all unrestricted gifts, grants, and other resources earned during the reporting period and (2) restricted resources to the extent that such funds were expended. Current funds revenues do not include restricted current funds received but not expended or resources that are restricted by external persons or agencies to other than current funds.

Interdepartmental transactions between service departments and storerooms and other institutional departments or offices should not be reported as revenues of the service departments but rather as reductions of expenditures of such departments, since these transactions are essentially interdepartmental transfers of costs. The billed price of services and materials obtained from service departments and central stores by offices and departments of the institution should be accounted for as expenditures of those offices and departments, just as if they had been obtained from sources outside the institution. Any difference between costs and billed prices as recorded in the service department account, whether credit or debit, should be reported under the Institutional Support expenditures classification.

Certain intrainstitutional transactions, however, should be reflected in the operating statements of the institution as revenues and expenditures. Materials or services produced by an instructional department by a by-product of the instructional program and sold to other departments or to auxiliary enterprises or hospitals—for example, milk sold by the dairy department to the dining halls—should be treated as sales and services revenues of the selling department and as expenditures of the receiving department. Sales and services of auxiliary enterprises to other departments—for example, catering by the food services department in the entertainment of institutional guests and sales by the college store to instructional departments—should be treated as sales and services revenues of the respective auxiliary enterprises and as expenditures of the unit receiving the services or materials.

Unrestricted and restricted current funds revenues should be grouped into the following major classifications by source of funds:

Tuition and Fees

Federal Appropriations

State Appropriations

Local Appropriations

Federal Grants and Contracts

State Grants and Contracts

Local Grants and Contracts

Private Gifts, Grants, and Contracts

Endowment Income

Sales and Services of Educational Activities

Sales and Services of Auxiliary Enterprises

Sales and Services of Hospitals

Other Sources, *including expired term endowments and expired life income agreements, if not material; otherwise, separate category*

Independent Operations

Tuition and Fees

This category should include all tuition and fees assessed against students (net of refunds) for educational purposes. Tuition and fees should be recorded as revenue even though there is no intention of collection from the student. The amounts of such remissions or waivers should be recorded as expenditures and classified as Scholarships and Fellowships or as staff benefits associated with the appropriate expenditure category to which the personnel relate.

When specific fees are assessed under binding external restrictions for other than current operating purposes—for example, debt service on educational plant or on renewals, replacements, or additions to plant—they should be reported as additions to the appropriate fund group (in the above example, plant funds), since they are not legally available for current operating purposes. Fees normally are not considered as assessed under binding external restrictions unless there is an explicit representation to the individuals remitting the fees that the fee or a specific portion thereof can be used only for the specific nonoperating purpose.

If some portion of total tuition or fee receipts is pledged under bond indenture agreements, the total receipts should be reported as unrestricted current funds revenues and the pledged amount treated as a mandatory transfer to plant funds.

If some portion of tuition or fees is allocated by action of the governing board, or subject to change by the governing board alone, for other than operating purposes, such as financing construction, the whole of the tuition charges or fees should be recorded as unrestricted current funds revenues and the portion allocated should be treated as a nonmandatory transfer to the appropriate fund group (in the above example, plant funds).

Revenues pledged under bond indenture agreements should not be reported as additions to plant funds, but should be reported as unrestricted current funds revenues, and funding of debt service requirements treated as mandatory transfers.

If an all-inclusive charge is made for tuition, board, room, and other services, a reasonable distribution should be made between revenues for tuition and revenues for sales and services of auxiliary enterprises.

Revenues from tuition and student fees of an academic term that encompasses two fiscal years—for example, a summer session—should be reported totally within the fiscal year in which the program is predominantly conducted.

If tuition or fees are remitted to the state as an offset to the state appropriation, the total of such tuition or fees should be deducted from the total for state appropriations and added to the total for tuition and fees.

Governmental Appropriations

This category includes (1) all unrestricted amounts received for current operations from, or made available to an institution by, legislative acts or local taxing authority and (2) restricted amounts from those same sources to the extent expended for current operations. This category does not include governmental grants and contracts. Amounts paid directly into a state or local retirement system by the appropriating government on behalf of the college or university should be recorded as revenue of the institution. This category does not include institutional fees and other income reappropriated by the legislature to the institution.

The determination of whether a particular government appropriation should be classified as restricted or unrestricted funds is based on the ability of the governing board of the institution to effect a change in the intended use of the funds. If a change in a particular restriction can be made without having to go through the legislative process, the funds should be considered unrestricted. Funds are unrestricted even if they are distributed to the institution for purposes specified by an intermediate group, such as the governing board. In this case, if a change in the use of funds needs to be made, it can be made by the intermediate body without going through the legislative process; the funds therefore would be unrestricted. Such appropriations should be considered unrestricted funds unless the restrictions are so specific that they substantially reduce the institution's flexibility in financial operations. Appropriations in terms of major object classes or to colleges and branch institutions should be classified as unrestricted current funds.

Governmental appropriations should be classified to identify the governmental level—federal, state, or local—of the legislative body making the appropriation to the institution. The fundor level is the level of the agent that makes the decision that the moneys will be appropriated to the particular purpose for which they ultimately are expended. For example, if the federal government stipulates a specific use for some funds that merely flow through the state to the institution, the funds should be classified as federal funds. However, if the federal government distributes funds to the state for unspecified general purposes—for example, general revenue sharing—and the state then appropriates all or a portion of those funds, the funds received by the institution should be classified as state rather than federal funds.

Governmental Grants and Contracts

This category includes (1) all unrestricted amounts received or made available by grants and contracts from governmental agencies for current operations and (2) all amounts received or made available through restricted grants and contracts to the extent expended for current operations.

Amounts equal to direct costs incurred by restricted current funds should be recorded as revenues of those funds, while amounts equal to associated indirect cost recoveries should be reported as unrestricted current funds revenues.

The government fundor level should be disclosed using the same criterion described for governmental appropriations.

Private Gifts, Grants, and Contracts

This category includes amounts from nongovernmental organizations and individuals, including funds resulting from contracting or the furnishing of goods and services of an instructional, research, or public service nature. It includes all unrestricted gifts, grants, and bequests as well as all restricted gifts, grants, and contracts from nongovernmental sources to the extent expended in the current fiscal year for current operations. Gifts, grants, and contracts from foreign governments should be treated as private gifts, grants, and contracts. Income from funds held in revocable trusts or distributable at the direction of the trustees of the trusts should be reported as a separate revenue source under this classification. This category excludes revenues derived from contracts and other activities, such as utility services, that are not related directly to instruction, research, or public service.

Amounts equal to the direct costs incurred by restricted current funds should be reported as revenues of those funds, while amounts equal to the associated indirect cost recoveries should be recorded as unrestricted current funds revenues.

Endowment Income

This category includes:

1. Unrestricted income from endowment and similar funds.
2. Restricted income from endowment and similar funds to the extent expended for current operations.
3. Income from funds held by others under irrevocable trusts, which should be identified separately under this revenue heading.

The unrestricted income from investments of endowment and similar funds credited to unrestricted current funds revenues should be the total ordinary income earned (or yield), except for income that must be added back to the principal in accordance with the terms of the agreement of donation. If endowment fund investments include real estate, the income should be reported on a net basis after allowing for all costs of operating and managing the properties.

Income from investments of endowment and similar funds does not include capital gains and losses, since such gains and losses are accounted for in the Endowment and Similar Funds group as additions to and deductions from fund balances. If any portion of the gains of endowment or quasi-endowment funds is utilized for current operating purposes, the portion so utilized should be reported as a transfer rather than as revenue (see Chapter 5:3).

When investments of endowment and similar funds are pooled, the amounts reported as revenues of unrestricted current funds and as additions to restricted current funds should be substantially equal to the amounts earned during the fiscal period and attributable to the various funds.

Many institutions have established endowment income stabilization reserves to spread or allocate current investment income. Two methods have been followed in establishing such reserves.

Under one method, a portion of the total revenue from the investment pool is not allocated to the participating funds, but is set aside in a stabilization reserve; the balance of the investment pool revenue is distributed to the participating funds. This method is not in accordance with generally accepted accounting principles for the following reasons:

1. The balance in the stabilization reserve may represent undistributed income attributable to both restricted and unrestricted current funds. Thus, the balance in the reserve cannot be reported accurately in the financial statements.
2. To the extent any of the undistributed income earned during the fiscal year is attributable to unrestricted current funds, an understatement of revenues of unrestricted current funds will occur.
3. Questions might arise as to the authority of the governing board to withhold amounts of income attributable to, but not distributed to, restricted current funds.

Institutions carrying balances in endowment income stabilization reserves created under this method should dispose of them as appropriate.

The second method, which conforms to generally accepted accounting principles, would distribute *all* income from the pools to the participating funds. The amount applicable to unrestricted current funds would be reported as endowment income. Any amounts set aside for a stabilization reserve should be shown as an allocation of the unrestricted current funds balance and appropriately reflected in the balance sheet as a subdivision of that balance. Amounts applicable to restricted current funds should be reported as an addition to those fund balances. The amounts expended from such balances should be shown as revenues of endowment income in the restricted current funds. Amounts unexpended would remain as balances to be carried forward to the next period.

Sales and Services of Educational Activities

This category includes (1) revenues that are related incidentally to the conduct of instruction, research, and public service and (2) revenues of activities that exist to provide an instructional and laboratory experience for students and that incidentally create goods and services that may be sold to students, faculty, staff, and the general public. The type of service rendered takes precedence over the form of agreement by which these services are rendered. Examples of revenues of educational activities are film rentals, sales of scientific and literary publications, testing services, and sales of products and services of dairy creameries, food technology divisions, poultry farms, and health clinics (apart from student health services) that are not part of a hospital. Revenues generated by hospitals (including health clinics that are a part thereof) should be classified as sales and services of hospitals.

If sales and services to students, faculty, or staff, rather than training or instruction, is the purpose of an activity, the revenue should be classified as sales and services of auxiliary enterprises or hospitals.

Sales and Services of Auxiliary Enterprises

This category includes all revenues generated through operations by auxiliary enterprises. An auxiliary enterprise is an entity that exists to furnish goods or services to students, faculty, or staff, and that charges a fee directly related to, although not necessarily equal to, the cost of the goods or services. The general public incidentally may be served by some auxiliary enterprises.

Auxiliary enterprises usually include residence halls, food services, intercollegiate athletics (if essentially self-supporting), college unions, college stores, and such services as barber shops, beauty parlors, and movie theaters. Even though they may serve students and faculty, hospitals are classified separately because of their size and relative financial importance.

This category is limited to revenues derived directly from the operation of the auxiliary enterprises themselves. Revenues from gifts, grants, or endowment income restricted for auxiliary enterprises should be reported under their respective source categories.

Sales and Services of Hospitals

This category includes revenues (net of discounts, allowances, and provision for doubtful accounts) generated by hospitals from daily patient, special, and other services. Revenues of health clinics that are part of a hospital should be included in this category. Not included are revenues for research and other specific-purpose gifts, grants, or endowment income restricted to the hospital. Such funds should be included in the appropriate revenue sources described above.

Other Sources

This category should include all sources of current funds revenue not included in other classifications. Examples are interest income and gains and losses on investments in current funds, miscellaneous rentals and sales, expired term endowments, and terminated annuity or life income agreements, if not material.

Note: It is appropriate to subtotal all revenues described; the subtotal excludes revenues of independent operations.

Transfers From Other Funds

Unrestricted amounts transferred from other fund groups back to the Current Funds group are not revenues of the current funds. An example is the return of quasi-endowment funds from the endowment and similar funds to unrestricted current funds. Such amounts should be identified separately and included in Nonmandatory Transfers (see expenditure categories).

Independent Operations

This category includes all revenues of those operations which are independent of, or unrelated to, but which may enhance the primary missions of the institution—instruction, research, and public service. Included are revenues associated with major federally funded research laboratories and other operations not considered an integral part of the institution's educational, auxiliary enterprise, or hospital activities. This category does not include the net profit (or loss) from operations owned and managed as investments of the institution's endowment funds.

Additions to Fund Balances

The term "additions" is in contrast to revenues and transfers. Additions are amounts received or made available to the restricted current funds during the reporting period as distinguished from the amounts of restricted funds expended during the fiscal period, which are reported as restricted fund revenues.

Current Funds Expenditures and Transfers

Current funds expenditures represent the costs incurred for goods and services used in the conduct of the institution's operations. They include the acquisition cost of capital assets, such as equipment and library books, to the extent current funds are budgeted for and used by operating departments for such purposes. If the amount of ending inventories or the cost of services benefiting subsequent fiscal periods is material (in terms of effect on financial statements), both inventories and deferred charges should be recorded as assets and previously recorded expenditures appropriately decreased. In a subsequent fiscal period these inventories and deferred charges as consumed should be included as expenditures of that period. Significant inventories of materials are usually present in central stores.

A capital asset is defined as any physical resource that benefits a program for more than one year. Capital expenditures therefore include funds expended for land, improvements to land, buildings, improvements and additions to buildings, equipment, and library books. Most institutional accounting systems provide for recording at least a portion of capital expenditures in the current fund expenditures accounts of the various operating units. Whether an expenditure is to be considered a capital expenditure is generally a matter for institutional determination, or in the case of some public institutions, it is prescribed by state regulation.

The general criteria for defining a capital asset are the relative significance of the amount expended and the useful life of the asset acquired, or in the case of repairs and alterations, the extent to which the useful life is extended. For expenditure reporting purposes, any item costing more than a specified amount, as determined by the institution or appropriate governmental unit, and having an expected useful life of more than one year generally should be classified as a capital expenditure.[1]

Interdepartmental transactions ordinarily should be accounted for as an increase in current fund expenditures of the department receiving the materials, services, or capital assets and as a decrease in current fund expenditures of the transferring department. Thus, total institutional expenditures are not inflated by the transactions. Examples are sales and services of service departments and central stores and transfers of material and equipment from one department to another. Any differences between the revenue from sales and services and the operating costs of service departments or central stores, whether debit or credit, are treated as Institutional Support expenditures. On the other hand, sales and services of an auxiliary enterprise to another department or auxiliary enterprise, or sales of materials produced by an instructional department to another department or auxiliary enterprise, would be reported as an expenditure of the department or auxiliary enterprise receiving the materials or services and as revenue of the department or auxiliary enterprise selling the materials or services.

Expenditures differ from transfers. Expenditures are the recognition of the expending of resources of the Current Funds group toward the objectives of each of the respective funds of that group. Transfers are amounts moved between fund groups to be used for the objectives of the recipient fund group. There are two types of transfers, mandatory and nonmandatory, which are fully described later in this chapter.

Expenditures and transfers may be classified in a variety of ways to serve a variety of purposes. Some of the factors bearing on the desired classification are:

1. The context in which appropriations, gifts, grants, and other sources of revenue are made to the institution.
2. The mode best suited for preparing and executing the budget.
3. The form that best serves the needs for financial reporting.
4. The presentation that will improve the quality of comparative studies among institutions.

Thus, expenditures and transfers may be classified in terms of programs, functions, organizational units, projects, and object classes.

Classifications by *program* often cut across organizational, functional, and even fund group lines and are useful in the planning processes. The *functional* classification pattern—educational and general, auxiliary enterprises, hospitals, independent operations, and their subcategories—provides the greatest comparability of data among institutions. The classification by *organizational units* provides data corresponding to channels of intra-institutional administrative responsibilities. Classification by *projects* serves to provide data corresponding to the pattern in which gifts, grants, and contracts are utilized by the institution. Classification by *object class*—that is, according to materials or capital assets purchased or services received, such as personal services, staff benefits, printing and stationery, travel, communications, food, fuel, utilities, repairs, equipment, and library books—serves internal management needs.

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[1] The Cost Accounting Standards Board (CASB) has stipulated $500 and a useful life of more than two years as the threshold at which items must be considered capital assets, and OMB Circular A-21 (formerly FMC Circular 73-8) defines equipment as items having an acquisition cost of $500 or more and an expected service life of two years or more. Different limits which are reasonable and consistently applied are acceptable.

Published financial reports usually classify expenditures and transfers in terms of function, organizational unit, and object, in that order.

It is suggested that the following functional classification be followed:

- Educational and General
  - Expenditures
    - Instruction
    - Research
    - Public Service
    - Academic Support
    - Student Services
    - Institutional Support
    - Operation and Maintenance of Plant
    - Scholarships and Fellowships
  - Mandatory Transfers
  - Nonmandatory Transfers
- Auxiliary Enterprises
  - Expenditures
  - Mandatory Transfers
  - Nonmandatory Transfers
- Hospitals
  - Expenditures
  - Mandatory Transfers
  - Nonmandatory Transfers
- Independent Operations
  - Expenditures
  - Mandatory Transfers
  - Nonmandatory Transfers

Educational and General

Instruction. This category should include expenditures for all activities that are part of an institution's instruction program, with the exception of expenditures for remedial and tutorial instruction, which should be categorized as Student Services. Expenditures for credit and noncredit courses, for academic, occupational, and vocational instruction, and for regular, special, and extension sessions should be included.

Expenditures for departmental research and public service that are not separately budgeted should be included in this classification. This category excludes expenditures for academic administration when the primary assignment is administration—for example, academic deans. However, expenditures for department chairmen, in which instruction is still an important role of the administrator, are included in this category.

Research. This category should include all expenditures for activities specifically organized to produce research outcomes, whether commissioned by an agency external to the institution or separately budgeted by an organizational unit within the institution. Subject to these conditions, it includes expenditures for individual and/or project research as well as those of institutes and research centers. This category does not include all sponsored programs (training grants are an example) nor is it necessarily limited to sponsored research, since internally supported research programs, if separately budgeted, might be included in this category under the circumstances described above. Expenditures for departmental research that are separately budgeted specifically for research are included in this category.

Public Service. This category should include funds expended for activities that are established primarily to provide noninstructional services beneficial to individuals and groups external to the institution. These activities include community service programs (excluding instructional activities) and cooperative extension services. Included in this category are conferences, institutes, general advisory services, reference bureaus, radio and television, consulting, and similar noninstructional services to particular sectors of the community.

Academic Support. This category should include funds expended primarily to provide support services for the institution's primary missions—instruction, research, and public service. It includes (1) the retention, preservation, and display of educational materials—for example, libraries, museums, and galleries; (2) the provision of services that directly assist the academic functions of the institution, such as demonstration schools associated with a department, school, or college of education; (3) media, such as audiovisual services and technology such as computing support; (4) academic administration (including academic deans but not department chairmen) and personnel development providing administrative support and management direction to the three primary missions; and (5) separately budgeted support for course and curriculum development. For institutions that currently charge certain of the expenditures—for example, computing support—directly to the various operating units of the institution, such expenditures are not reflected in this category.

Student Services. This category should include funds expended for offices of admissions and registrar and those activities whose primary purpose is to contribute to the student's emotional and physical well-being and to his intellectual, cultural, and social development outside the context of the formal instruction program. It includes expenditures for student activities, cultural events, student newspapers, intramural athletics, student organizations, intercollegiate athletics (if the program is operated as an integral part of the department of physical education and not as an essentially self-supporting activity), supplemental educational services to provide matriculated students with supplemental instruction outside of the normal academic program (remedial instruction is an example), counseling and career guidance (excluding informal academic counseling by the faculty), student aid administration, and student health service (if not operated as an essentially self-supporting activity).

Institutional Support. This category should include expenditures for: (1) central executive-level activities concerned with management and long-range planning of the entire institution, such as the governing board, planning and programming, and legal services; (2) fiscal operations, including the investment office; (3) administrative data processing; (4) space management; (5) employee personnel and records; (6) logistical activities that provide procurement, storerooms, safety, security, printing, and transportation services to the institution; (7) support services to faculty and staff that are not operated as auxiliary enterprises; and (8) activities concerned with community and alumni relations, including development and fund raising.

Appropriate allocations of institutional support should be made to auxiliary enterprises, hospitals, and any other activities not reported under the Educational and General heading of expenditures.

Operation and Maintenance of Plant. This category should include all expenditures of current operating funds for the operation and maintenance of physical plant, in all cases net of amounts charged to auxiliary enterprises, hospitals, and independent operations. It does not include expenditures made from the institutional plant fund accounts. It includes all expenditures for operations established to provide services and maintenance related to grounds and facilities. Also included are utilities, fire protection, property insurance, and similar items.

Scholarships and Fellowships. This category should include expenditures for scholarships and fellowships in the form of outright grants to students selected by the institution and financed from current funds, restricted or unrestricted. It also should include trainee stipends, prizes, and awards, except trainee stipends awarded to individuals who are not enrolled in formal course work, which should be charged to instruction, research, or public service as appropriate. If the institution is given custody of the funds, but is not allowed to select the recipient of the grant—for example, the federal Basic Educational Opportunity Grants program or ROTC scholarships—the funds should be reported in the Agency Funds group rather than in the Current Funds group. The recipient of an outright grant is not required to perform service to the institution as consideration for the grant, nor is he expected to repay the amount of the grant to the funding source. When services are required in exchange for financial assistance, as in the federal College Work-Study Program, the charges should be classified as expenditures of the department or organizational unit to which the service is rendered. Aid to students in the form of tuition or fee remissions also should be included in this category. However, remissions of tuition or fees granted because of faculty or staff status, or family relationship of students to faculty or staff, should be recorded as staff benefit expenditures in the appropriate functional expenditure category.

Mandatory Transfers. This category should include transfers from the Current Funds group to other fund groups arising out of (1) binding legal agreements related to the financing of educational plant, such as amounts for debt retirement, interest, and required provisions for renewals and replacements of plant not financed from other sources and (2) grant agreements with agencies of the federal government, donors, and other organizations to match gifts and grants to loan and other funds. Mandatory transfers may be required to be made from either unrestricted or restricted current funds.

Nonmandatory Transfers. This category should include those transfers from the Current Funds group to other fund groups made at the discretion of the governing board to serve a variety of objectives, such as additions to loan funds, additions to quasi-endowment funds, general or specific plant additions, voluntary renewals and replacements of plant, and prepayments on debt principal. It also may include the retransfer of resources back to current funds.

Auxiliary Enterprises

An auxiliary enterprise is an entity that exists to furnish goods or services to students, faculty, or staff, and that charges a fee directly related to, although not necessarily equal to, the cost of the goods or services. The distinguishing characteristic of auxiliary enterprises is that they are managed as essentially self-supporting activities. Examples are residence halls, food services, intercollegiate athletics, (only if essentially self-supporting), college stores, faculty clubs, faculty and staff parking, and faculty housing. Student health services, when operated as an auxiliary enterprise, also should be included. The general public may be served incidentally by auxiliary enterprises. Hospitals, although they may serve students, faculty, or staff, are separately classified because of their relative financial significance.

This category includes all expenditures and transfers relating to the operation of auxiliary enterprises, including expenditures for operation and maintenance of plant and for institutional support; also included are other direct and indirect costs, whether charged directly as expenditures or allocated as a proportionate share of costs of other departments or units.

Expenditures. Expenditures of auxiliary enterprises are identified by using the same general criteria as for educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. This type of transfer follows the same criteria of identification as for educational and general mandatory transfers to distinguish them from expenditures and nonmandatory transfers.

Nonmandatory Transfers. This type of transfer follows the same criteria of identification as for educational and general nonmandatory transfers in order to distinguish them from expenditures and mandatory transfers.

Hospitals

This category includes all expenditures and transfers associated with the patient care operations of the hospital, including nursing and other professional services, general services, administrative services, fiscal services, and charges for physical plant operations and institutional support. Also included are other direct and indirect costs, whether charged directly as expenditures or allocated as a proportionate share of costs of other departments or units. Expenditures for those activities which take place within the hospital, but which are categorized more appropriately as instruction or research, should be excluded from this category and accounted for in the appropriate categories.

Expenditures. The same criteria for identifying expenditures are used as in the case of educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. The same criteria for identifying mandatory transfers are used as in the case of educational and general mandatory transfers to distinguish them from expenditures and nonmandatory transfers.

Nonmandatory Transfers. The same criteria for identifying nonmandatory transfers are used as in the case of educational and general nonmandatory transfers to distinguish them from expenditures and mandatory transfers.

Independent Operations

This category includes expenditures and transfers of those operations which are independent of, or unrelated to, but which may enhance the primary missions of the institution. This category generally is limited to expenditures associated with major federally funded research laboratories. This category excludes expenditures associated with property owned and managed as investments of the institution's endowment funds.

Expenditures. The same criteria for identifying expenditures are used as in the case of educational and general expenditures to distinguish them from transfers.

Mandatory Transfers. The same criteria for identifying mandatory transfers are used as in the case of educational and general mandatory transfers to distinguish them from expenditures and nonmandatory transfers.

Nonmandatory Transfers. The same criteria for identifying nonmandatory transfers are used as in the case of educational and general nonmandatory transfers to distinguish them from expenditures and mandatory transfers.

Deductions from Fund Balances

The term "deductions" is in contrast to expenditures and transfers. Deductions represent decreases in current fund balances, such as refunds to donors and grantors, and unencumbered or unexpended funds returned or returnable to the state treasury at fiscal year-end, depending on provisions of state statutes or appropriation acts.

Illustrative Exhibits *

The figures used in the accompanying exhibits are illustrative only and are not intended to indicate any relationship among accounts. The summary of significant accounting policies and notes to financial statements relate to the illustrative statements. Modifications should be made thereto as appropriate to actual circumstances.

The exhibits illustrate financial statements of an educational institution and the accompanying disclosures that are unique to or common among such institutions. In addition, to the notes illustrated, financial statements of educational institutions should include other appropriate disclosures. Such disclosures might include, among other items, information concerning related-party transactions, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, lease commitments, extraordinary items, accounting changes, off-balance-sheet risks, concentrations of credit risk, the fair value of financial instruments, and other matters, that are not unique to educational institutions.

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Exhibit 1

SAMPLE EDUCATIONAL INSTITUTION

Balance Sheet

June 30, 19__

with comparative figures at June 30, 19__

Assets	Current year	Prior year
Current funds:		
Unrestricted:		
Cash	$ 210,000	110,000
Investments	450,000	360,000
Accounts receivable, less allowance of $18,000 both years	228,000	175,000
Inventories, at lower of cost (first-in, first-out basis) or market	90,000	80,000
Prepaid expenses and deferred charges	28,000	20,000
Total unrestricted	1,006,000	745,000
Restricted:		
Cash	145,000	101,000
Investments	175,000	165,000
Accounts receivable, less allowance of $8,000 both years	68,000	160,000
Unbilled charges	72,000	—
Total restricted	460,000	426,000
Total current funds	1,466,000	1,171,000

Liabilities and Fund Balances	Current year	Prior year
Current funds:		
Unrestricted:		
Accounts payable	$ 125,000	100,000
Accrued liabilities	20,000	15,000
Students' deposits	30,000	35,000
Due to other funds	158,000	120,000
Deferred credits	30,000	20,000
Fund balance	643,000	455,000
Total unrestricted	1,006,000	745,000
Restricted:		
Accounts payable	14,000	5,000
Fund balances	446,000	421,000
Total restricted	460,000	426,000
Total current funds	1,466,000	1,171,000

Continued

SAMPLE EDUCATIONAL INSTITUTION
Balance Sheet, Continued

Assets, Continued	Current year	Prior year
Loan funds:		
Cash	$ 30,000	20,000
Investments	100,000	100,000
Loans to students, faculty, and staff, less allowance of $10,000 current year and $9,000 prior year	550,000	382,000
Due from unrestricted funds	3,000	—
Total loan funds	683,000	502,000
Endowment and similar funds:		
Cash	100,000	101,000
Investments	13,900,000	11,800,000
Total endowment and similar funds	14,000,000	11,901,000
Annuity and life income funds:		
Annuity funds:		
Cash	55,000	45,000
Investments	3,260,000	3,010,000
Total annuity funds	3,315,000	3,055,000
Life income funds:		
Cash	15,000	15,000
Investments	2,045,000	1,740,000
Total life income funds	2,060,000	1,755,000
Total annuity and life income funds	5,375,000	4,810,000

Liabilities and Fund Balances, Continued	Current year	Prior year
Loan funds:		
Fund balances:		
U.S. government grants refundable	$ 50,000	33,000
University funds:		
Restricted	483,000	369,000
Unrestricted	150,000	100,000
Total loan funds	683,000	502,000
Endowment and similar funds:		
Fund balances:		
Endowment	7,800,000	6,740,000
Term endowment	3,840,000	3,420,000
Quasi-endowment — unrestricted	1,000,000	800,000
Quasi-endowment — restricted	1,360,000	941,000
Total endowment and similar funds	14,000,000	11,901,000
Annuity and life income funds:		
Annuity funds:		
Annuities payable	2,150,000	2,300,000
Fund balances	1,165,000	755,000
Total annuity funds	3,315,000	3,055,000
Life income funds:		
Income payable	5,000	5,000
Fund balances	2,055,000	1,750,000
Total life income funds	2,060,000	1,755,000
Total annuity and life income funds	5,375,000	4,810,000

SAMPLE EDUCATIONAL INSTITUTION
Balance Sheet, continued

Plant funds:			Plant funds:		
Unexpended:			Unexpended:		
Cash	$ 275,000	410,000	Accounts payable	10,000	—
Investments	1,285,000	1,590,000	Notes payable	100,000	—
Due from unrestricted current funds	150,000	120,000	Bonds payable	400,000	—
			Fund balances:		
			Restricted	1,000,000	1,860,000
			Unrestricted	200,000	260,000
Total unexpended	1,710,000	2,120,000	Total unexpended	1,710,000	2,120,000
Renewals and replacements:			Renewals and replacements:		
Cash	5,000	4,000	Fund balances:		
Investments	150,000	286,000	Restricted	25,000	180,000
Deposits with trustees	100,000	90,000	Unrestricted	235,000	200,000
Due from unrestricted current funds	5,000	—			
Total renewals and replacements	260,000	380,000	Total renewals and replacements	260,000	380,000
Retirement of indebtedness:			Retirement of indebtedness:		
Cash	50,000	40,000	Fund balances:		
Deposits with trustees	250,000	253,000	Restricted	185,000	125,000
			Unrestricted	115,000	168,000
Total retirement of indebtedness	300,000	293,000	Total retirement of indebtedness	300,000	293,000

Continued

SAMPLE EDUCATIONAL INSTITUTION
Balance Sheet, Continued

Assets, Continued	Current year	Prior year	Liabilities and Fund Balances, Continued	Current year	Prior year
Investment in plant:			Investment in plant:		
Land	500,000	500,000	Notes payable	790,000	810,000
Land improvements	1,000,000	1,110,000	Bonds payable	2,200,000	2,400,000
Buildings	25,000,000	24,060,000	Mortgages payable	400,000	200,000
Equipment	15,000,000	14,200,000	Net investment in plant	38,210,000	36,540,000
Library books	100,000	80,000			
Total investment in plant	41,600,000	39,950,000	Total investment in plant	41,600,000	39,950,000
Total plant funds	43,870,000	42,743,000	Total plant funds	43,870,000	42,743,000
Agency funds:			Agency funds:		
Cash	50,000	70,000	Deposits held in custody for others	110,000	90,000
Investments	60,000	20,000			
Total agency funds	110,000	90,000	Total agency funds	110,000	90,000

See accompanying Summary of Significant Accounting Policies and Notes to Financial Statements

Exhibit 2

SAMPLE EDUCATIONAL INSTITUTION

Statement of Changes in Fund Balances
Year Ended June 30, 19__

	Current Funds					Plant Funds			
	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Unexpended	Renewal and Replacements	Retirement of Indebtedness	Investment in Plant
Revenues and other additions:									
Unrestricted current fund revenues	$7,540,000								
Expired term endowment—restricted						$50,000			
State appropriations—restricted						50,000			
Federal grants and contracts—restricted		$500,000							
Private gifts, grants, and contracts—restricted		370,000	$100,000	$1,500,000	$800,000	115,000		$65,000	$15,000
Investment income—restricted		224,000	12,000	10,000		$5,000	5,000	5,000	
Realized gains on investments—unrestricted				109,000					
Realized gains on investments—restricted			4,000	50,000		10,000	5,000	5,000	
Interest on loans receivable			7,000						
U.S. government advances			18,000						
Expended for plant facilities (including $100,000 charged to current funds expenditures)									1,550,000
Retirement of indebtedness									220,000
Accrued interest on sale of bonds								3,000	
Matured annuity and life income restricted to endowment				10,000					
Total revenues and other additions	7,540,000	1,094,000	141,000	1,679,000	800,000	230,000	10,000	78,000	1,785,000

Continued

SAMPLE EDUCATIONAL INSTITUTION

Statement of Changes in Fund Balances—continued

	Current Funds					Plant Funds			
	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Annuity and Life Income Funds	Unexpended	Renewal and Replacements	Retirement of Indebtedness	Investment in Plant
Expenditures and other deductions:									
Educational and general expenditures	4,400,000	1,014,000							
Auxiliary enterprises expenditures	1,830,000								
Indirect costs recovered		35,000							
Refunded to grantors		20,000	10,000						
Loan cancellations and write-offs			1,000						
Administrative and collection costs			1,000					1,000	
Adjustment of actuarial liability for annuities payable					75,000				
Expended for plant facilities (including noncapitalized expenditures of $50,000)						1,200,000	300,000		
Retirement of indebtedness								220,000	
Interest on indebtedness								190,000	
Disposal of plant facilities									115,000
Expired term endowments ($40,000 unrestricted, $50,000 restricted to plant)				90,000					
Matured annuity and life income funds restricted to endowment					10,000				
Total expenditures and other deductions	6,230,000	1,069,000	12,000	90,000	85,000	1,200,000	300,000	411,000	115,000
Transfers among funds—additions/(deductions):									
Mandatory:									

SAMPLE EDUCATIONAL INSTITUTION
Statement of Changes in Fund Balances—continued
Year Ended June 30, 19__

Principal and interest	(340,000)							340,000	
Renewals and replacements	(170,000)						170,000		
Loan fund matching grant	(2,000)		2,000						
Unrestricted gifts allocated	(650,000)		50,000	550,000		50,000			
Portion of unrestricted quasi-endowment funds investment gains appropriated	40,000			(40,000)					
Total transfers	(1,122,000)		52,000	510,000		50,000	170,000	340,000	
Net increase/(decrease) for the year	188,000	25,000	181,000	2,099,000	715,000	(920,000)	(120,000)	7,000	1,670,000
Fund balance at beginning of year	455,000	421,000	502,000	11,901,000	2,505,000	2,120,000	380,000	293,000	36,540,000
Fund balance at end of year	$643,000	$446,000	$683,000	$14,000,000	$3,220,000	$1,200,000	$260,000	$300,000	$38,210,000

See accompanying Summary of Significant Accounting Policies and Notes to Financial Statements

Continued

Exhibit 3

SAMPLE EDUCATIONAL INSTITUTION

Statement of Current Funds Revenues, Expenditures, and Other Changes
Year Ended June 30, 19__

	Current Year			Prior
	Unrestricted	Restricted	Total	Year Total
Revenues:				
Tuition and fees	$2,600,000		2,600,000	2,300,000
Federal appropriations	500,000		500,000	500,000
State appropriations	700,000		700,000	700,000
Local appropriations	100,000		100,000	100,000
Federal grants and contracts	20,000	375,000	395,000	350,000
State grants and contracts	10,000	25,000	35,000	200,000
Local grants and contracts	5,000	25,000	30,000	45,000
Private gifts, grants, and contracts	850,000	380,000	1,230,000	1,190,000
Endowment income	325,000	209,000	534,000	500,000
Sales and services of educational departments	190,000		190,000	195,000
Sales and services of auxiliary enterprises	2,200,000		2,200,000	2,100,000
Expired term endowment	40,000		40,000	
Other sources (if any)				
Total current revenues	7,540,000	1,014,000	8,554,000	8,180,000
Expenditures and mandatory transfers:				
Educational and general:				
Instruction	2,960,000	489,000	3,449,000	3,300,000
Research	100,000	400,000	500,000	650,000
Public service	130,000	25,000	155,000	175,000
Academic support	250,000		250,000	225,000
Student services	200,000		200,000	195,000
Institutional support	450,000		450,000	445,000

SAMPLE EDUCATIONAL INSTITUTION

Statement of Current Funds Revenues, Expenditures, and Other Changes—Continued

	Current Year			Prior
	Unrestricted	Restricted	Total	Year Total
Operation and maintenance of plant	220,000		220,000	200,000
Scholarships and fellowships	90,000	100,000	190,000	180,000
Educational and general expenditures	4,400,000	1,014,000	5,414,000	5,370,000
Mandatory transfers for:				
Principal and interest	90,000		90,000	50,000
Renewals and replacements	100,000		100,000	80,000
Loan fund matching grant	2,000		2,000	
Total educational and general	4,592,000	1,014,000	5,606,000	5,500,000
Auxiliary enterprises:				
Expenditures	1,830,000		1,830,000	1,730,000
Mandatory transfers for:				
Principal and interest	250,000		250,000	250,000
Renewals and replacements	70,000		70,000	70,000
Total auxiliary enterprises	2,150,000		2,150,000	2,050,000
Total expenditures and mandatory transfers	6,742,000	1,014,000	7,756,000	7,550,000
Other transfers and additions/(deductions):				
Excess of restricted receipts over transfers to revenues		45,000	45,000	40,000
Refunded to grantors		(20,000)	(20,000)	
Unrestricted gifts allocated to other funds	(650,000)		(650,000)	(510,000)
Portion of quasi-endowment gains appropriated	40,000		40,000	
Net increase in fund balances	188,000	25,000	213,000	160,000

See accompanying Summary of Significant Accounting Policies and Notes to Financial Statements

Continued

Sample Educational Institution

Summary of Significant Accounting Policies

June 30, 19__

The significant accounting policies followed by Sample Educational Institution are described below to enhance the usefulness of the financial statements to the reader.

Accrual Basis

The financial statements of Sample Educational Institution have been prepared on the accrual basis except for depreciation accounting as explained in notes 1 and 2 to the financial statements. The statement of current funds revenues, expenditures, and other changes is a statement of financial activities of current funds related to the current reporting period. It does not purport to present the results of operations or the net income or loss for the period as would a statement of income or a statement of revenues and expenses.

To the extent that current funds are used to finance plant assets, the amounts so provided are accounted for as (1) expenditures, in the case of normal replacement of movable equipment and library books; (2) mandatory transfers, in the case of required provisions for debt amortization and interest and equipment renewal and replacement; and (3) transfers of a nonmandatory nature for all other cases.

Fund Accounting

In order to ensure observance of limitations and restrictions placed on the use of the resources available to the Institution, the accounts of the Institution are maintained in accordance with the principles of "fund accounting." This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds that are in accordance with activities or objectives specified. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

Within each fund group, fund balances restricted by outside sources are so indicated and are distinguished from unrestricted funds allocated to specific purposes by action of the governing board. Externally restricted funds may only be utilized in accordance with the purposes established by the source of such funds and are in contrast with unrestricted funds over which the governing board retains full control to use in achieving any of its institutional purposes.

Endowment funds are subject to the restrictions of gift instruments requiring in perpetuity that the principal be invested and the income only be utilized. Term endowment funds are similar to endowment funds except that upon the passage of a stated period of time or the occurrence of a particular event, all or part of the principal may be expended. While quasi-endowment funds have been established by the governing board for the same purposes as endowment funds, any portion of quasi-endowment funds may be expended.

All gains and losses arising from the sale, collection, or other disposition of investments and other noncash assets are accounted for in the fund which owned such assets. Ordinary income derived from investments, receivables, and the like is accounted for in the fund owning such assets, except for income derived from investments of endowment and similar funds, which income is accounted for in the fund to which it is restricted or, if unrestricted, as revenues in unrestricted current funds.

All other unrestricted revenue is accounted for in the unrestricted current fund. Restricted gifts, grants, appropriations, endowment income, and other restricted resources are accounted for in the appropriate restricted funds. Restricted current funds are reported as revenues and expenditures when expended for current operating purposes.

Other Significant Accounting Policies

Other significant accounting policies are set forth in the financial statements and the notes thereto.

Sample Educational Institution

Notes to Financial Statements

June 30, 19__

1. Investments exclusive of physical plant are recorded at cost; investments received by gift are carried at market value at the date of acquisition. Quoted market values of investments (all marketable securities) of the funds indicated were as follows:

	Current year	*Prior year*
Unrestricted current funds	$ 510,000	$ 390,000
Restricted current funds	180,000	165,000
Loan funds	105,000	105,000
Unexpended plant funds	1,287,000	1,600,000
Renewal and replacement funds	145,000	285,000
Agency funds	60,000	20,000

Investments of endowment and similar funds and annuity and life income funds are composed of the following:

	Carrying value	
	Current year	*Prior year*
Endowment and similar funds:		
Corporate stocks and bonds (approximate market, current year $15,000,000, prior year $10,900,000)	$13,000,000	$10,901,000
Rental properties—less accumulated depreciation, current year $500,000, prior year $400,000	900,000	899,000
	13,900,000	11,800,000
Annuity funds:		
U.S. bonds (approximate market, current year $200,000, prior year $100,000)	$ 200,000	$ 110,000
Corporate stocks and bonds (approximate market, current year $3,070,000, prior year $2,905,000)	3,060,000	2,900,000
	3,260,000	3,010,000
Life income funds:		
Municipal bonds (approximate market, current year $1,400,000, prior year $1,340,000)	$ 1,500,000	$ 1,300,000

Corporate stocks and bonds (approximate market, current year $650,000, prior year $400,000)	545,000	440,000
	2,045,000	1,740,000

Assets of endowment funds, except nonmarketable investments of term endowment having a book value of $200,000 and quasi-endowment having a book value of $800,000, are pooled on a market value basis, with each individual fund subscribing to or disposing of units on the basis of the value per unit at market value at the beginning of the calendar quarter within which the transaction takes place. Of the total units, each having a market value of $15.00, 600,000 units were owned by endowment, 280,000 units by term endowment, and 120,000 units by quasi-endowment at June 30, 19__.

The following tabulation summarizes changes in relationships between cost and market values of the pooled assets:

	Pooled Assets		*Net Gains (Losses)*	*Market Value per Unit*
	Market	*Cost*		
End of year	$15,000,000	$13,000,000	$2,000,000	$15.00
Beginning of year	10,900,000	10,901,000	(1,000)	12.70
Unrealized net gains for year			2,001,000	
Realized net gains for year			159,000	
Total net gains for year			2,160,000	2.30

The average annual earnings per unit, exclusive of net gains, were $.56 for the year.

2. Physical plant and equipment are stated at cost at date of acquisition or fair value at date of donation in the case of gifts, except land acquired prior to 1940, which is valued at appraisal value in 1940 at $300,000. Depreciation on physical plant and equipment is not recorded.

3. Long-term debt includes: bonds payable due in annual installments varying from $45,000 to $55,000 with interest at 5 7/8%, the final installment being due in 19__, collateralized by trust indenture covering land, buildings, and equipment known as Smith dormitory carried in the accounts at $2,500,000, and pledged net revenue from the operations of said dormitory; and mortgages payable due in varying amounts to 19__ with interest at 6%, collateralized by property carried in the accounts at $800,000 and pledged revenue of the Student Union amounting to approximately $65,000 per year.*

4. [Pension note deleted—See FASB Statement No. 87, *Employers' Accounting for Pensions* or GASB Statement No. 5, *Disclosure of Pension Infor-*

* FASB Statement No. 47, *Disclosure of Long-Term Obligations,* also requires disclosure of maturities of long-term obligations for each of the five years following the balance sheet date.

mation by Public Employee Retirement Systems and State and Local Governmental Employers, for current disclosure requirements.]

5. Contracts have been let for the construction of additional classroom buildings in the amount of $3,000,000. Construction and equipment are estimated to aggregate $5,000,000, which will be financed by available resources and an issue of bonds payable over a period of 40 years amounting to $4,000,000.

6. All interfund borrowings have been made from unrestricted funds. The amounts due to plant funds from current unrestricted funds are payable within one year without interest. The amount due to loan funds from current unrestricted funds is payable currently.

7. Pledges totaling $260,000, restricted to plant fund uses, are due to be collected over the next three fiscal years in the amounts of $120,000, $80,000, and $60,000, respectively. It is not practicable to estimate the net realizable value of such pledges.

Chart of Accounts

A systematic classification of accounts is an essential part of an accounting system. The accounts should be developed to be compatible with the organizational structure of the institution, and their form and content should be arranged in agreement with the financial reports to be presented.

The arrangement should be formalized in a chart of accounts, and, for ease of identification and reference, each account should be assigned an appropriate code number or symbol. Classification should be according to the funds and fund groups of the institution, as described in the preceding chapters of Part 5. Within each fund group, the accounts should be listed according to assets, liabilities, and fund balance accounts.

The illustrative chart of accounts for a college or university presented below shows those accounts usually found in the general ledger or carried in subsidiary ledgers with appropriate control accounts in the general ledger. This chart is presented as a guide for institutions in developing their own detailed charts of accounts and to help them set up their accounts in conformity with the principles of accounting and reporting presented in the preceding chapters of Part 5. The system of accounts may be expanded, contracted, or modified to meet the needs of the individual institution and to conform to its organizational structure, but in any case it should incorporate the basic elements common to all educational institutions.

In designing or revising a chart of accounts, the code numbers or symbols assigned to the accounts should progress in a logical order. Because each fund and fund group is carried in the accounting records as a separately balanced group, the accounts in any given group should be assigned a code number that, perhaps by a prefix, identifies that fund group—for example, all accounts related to current funds should be identifiable as such; all accounts for plant funds should be identifiable as such. Similarly, within the fund groups, consistent code numbers should identify subgroups, assets, liabilities, and fund balances. For revenue accounts, code numbers or symbols can be used to identify sources. For expenditure accounts, code numbers or symbols can be used to identify functions, organizational units, projects, programs, and objects of expenditures. The individual fund identity should be an integral part of the fund balance, revenue, and expenditure account codes.

In developing a chart of accounts, it is important to exercise economy in the use of digits and characters for code numbers, to plan a logical arrangement for the chart, and to make ample provision for future expansion of account numbers.

General Ledger Accounts

Current Funds—Unrestricted

Asset Accounts

Cash

Petty Cash

Investments

Accounts Receivable—*detailed as needed, for example:*

Students

Hospital Patients

Governmental

Unbilled Charges

Notes Receivable—*detailed as needed*

Allowance for Doubtful Accounts and Notes—*credit balance account associated with each type of receivable*

Inventories—*detailed as needed, for example:*

College Store

Dining Halls

Central Stores

Plant Operation and Maintenance Supply Store

Prepaid Items and Deferred Charges—*detailed as needed*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Notes Payable

Accounts Payable and Accrued Expenses—*detailed as needed*

Deferred Credits

Deposits

Due to Other Fund Groups

Fund Balances—Allocated—*detailed as needed, for example:*

Auxiliary Enterprises

Reserve for Encumbrances

Reserve for Computer Use Survey

Reserve for Faculty Self-Improvement Program

Fund Balance—Unallocated

Operating Accounts. The following control accounts in the general ledger for actual revenues, expenditures, and other changes are supported in detail by Current Funds Revenues and Current Funds Expenditures and Other Changes accounts in subsidiary ledgers. If desired, several control accounts may be provided in lieu of single control accounts:

Revenues Control—*credit account*

Expenditures and Other Changes Control—*debit account*

When budgetary accounts are carried in the general ledger, the following control accounts would appear in the chart of accounts. They are supported in detail by Current Funds Revenues and Current Funds Expenditures and Other Changes accounts in subsidiary ledgers:

Estimated Revenues *or* Unrealized Revenues

Expenditures and Other Changes Allocations or Budget Allocations for Expenditures and Other Changes

Unallocated Budget Balance or Unassigned Budget Balance

Current Funds—Restricted

These accounts are to be used if the assets and liabilities of such funds are separated from those of Unrestricted Current Funds.

Asset Accounts

Cash

Investments

Accounts Receivable—*detailed as needed, for example:*

Governmental

Other

Unbilled Charges

Allowance for Doubtful Accounts—*credit balance account*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Due to Other Fund Groups

Fund Balances—Allocated—*detailed as needed, for example:*

Reserve for Encumbrances

Auxiliary Enterprises

Fund Balances—Unallocated

Both of the fund balance accounts may be control accounts supported by separate subsidiary ledger accounts for each restricted current fund and for each type of fund balance. Additional control accounts may be provided as required or desired.

Operating Accounts. Expenditures of restricted current funds may be recorded in the operating accounts of unrestricted current funds, in which case transfers of restricted current funds to current funds revenues accounts would be made to finance such expenditures. When this is not done, operating accounts for each current restricted fund must provide for proper classification of expenditures by object, as well as providing for appropriate categorization of sources of additions, deductions other than expenditures, and transfers to and from other funds.

Loan Funds

Asset Accounts

Cash

Investments

Notes Receivable from Students, Faculty, and Staff

Allowance for Doubtful Loans—*credit balance account*

Liability and Fund Balance Accounts

Accounts Payable to Collection Agencies

Due to Other Fund Groups

Refunds Payable on Refundable Government Grants

Fund Balances—This may be a control account supported by separate subsidiary ledger accounts for each fund. Separate accounts should be carried to identify the sources of funds available for loans, such as donor- and government-restricted loan funds, including funds provided by mandatory transfers required for matching purposes, unrestricted funds designated as loan funds, and funds returnable to the donor under certain conditions. Accounts to identify allocations of fund balances should be provided. Accounts may be maintained to identify resources available for loans to students separately from those for faculty and staff.

Endowment and Similar Funds

Asset Accounts

Cash

Accounts Receivable

Notes Receivable

Allowance for Doubtful Accounts and Notes—*credit balance account*

Prepaid Items

Investments—*detailed as needed, for example:*

Bonds

Allowance for Unamortized Bond Premiums

Allowance for Unamortized Bond Discounts

Preferred Stocks

Common Stocks

Mortgage Notes

Real Estate

Allowance for Depreciation—*credit balance account*

Due from Other Fund Groups

Liability and Fund Balance Accounts

The fund balance accounts should be classified as to Endowment, Term Endowment, and Quasi-Endowment Funds, even though the investments of the funds may be merged in one or more investment pools.

Payables—*detailed as needed, for example:*

Mortgages Payable

Notes Payable

Accounts Payable

Collateral Due on Securities Loaned

Due to Other Fund Groups

Balances of Endowment Funds

Balances of Term Endowment Funds

Balances of Quasi-Endowment Funds—Unrestricted

Balances of Quasi-Endowment Funds—Restricted

In order to differentiate between the balances of funds for which the income is unrestricted and those for which the income is restricted, the following accounts may be employed:

Balances of Endowment Funds—Unrestricted

Balances of Endowment Funds—Restricted—*detailed as needed, for example:*

Professorships

Instructional Departments

Scholarships

Library

Loan Funds

Note. The balances of term endowment funds also may be identified in this manner.

Undistributed Gains and Losses on Investment Transactions—*Separate accounts should be established for each investment pool.*

Undistributed Share Adjustments—*Separate accounts should be established for each investment pool.*

Annuity and Life Income Funds

If the funds in this section are pooled for investment purposes, accounts for the assets may be classified as shown below for each investment pool. If any funds are separately invested, accounts should be set up for the investment of such funds.

Asset Accounts

Cash

Accounts Receivable

Notes Receivable

Allowance for Doubtful Accounts and Notes—*credit balance account*

Investments—*detailed as needed, for example:*

Bonds

Allowance for Unamortized Bond Premiums

Allowance for Unamortized Bond Discounts

Preferred Stocks

Common Stocks

Mortgage Notes

Real Estate

Allowance for Depreciation—*credit balance account*

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Annuity Payments Currently Due

Annuities Payable

Life Income Payments Currently Due

Due to Other Funds for Advances on Annuity Payments

Due to Other Funds for Advances to Income Beneficiaries

Undistributed Income—Annuity Funds

Undistributed Income—Life Income Funds

Balances of Annuity Funds

Balances of Life Income Funds

These may be control accounts supported by subsidiary ledger accounts for each fund. Within the two categories the accounts may be listed alphabetically by name, or they may be classified in any other manner at the discretion of the institution.

Undistributed Gains and Losses on Investment Transactions—*Separate accounts should be established for each investment pool.*

Undistributed Share Adjustments—*Separate accounts should be established for each investment pool.*

Income, Expenditure, and Transfer Accounts

Income from Investments—*credit account, detailed by each agreement*

Expenditures and Transfers—*debit account, detailed by each agreement*

Plant Funds—Unexpended

Asset Accounts

Cash

Investments

Receivables—*detailed as needed*

Allowance for Doubtful Accounts—*credit balance account*

Due from Other Fund Groups

Construction in Progress—*alternatively can be shown in Investment in Plant subgroup of Plant Funds*

Liability and Fund Balance Accounts

Accounts Payable

Notes Payable

Bonds Payable

Mortgages Payable

Due to Other Fund Groups

Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Funds for Renewals and Replacements

These accounts should be used if the assets of such funds are separated from the assets of other subgroups of Plant Funds.

Asset Accounts

Cash

Accounts Receivable

Allowance for Doubtful Accounts—*credit balance account*

Investments

Deposits with Trustees

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Due to Other Fund Groups

Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Funds for Retirement of Indebtedness

These accounts should be used if the assets of such funds are separated from the assets of other subgroups of Plant Funds.

Asset Accounts

Cash

Accounts and Notes Receivable

Allowance for Doubtful Accounts—*credit balance account*

Investments

Deposits with Trustees

Due from Other Fund Groups

Liability and Fund Balance Accounts

Accounts Payable

Due to Other Fund Groups

Fund Balances—*This may be a control account supported by subsidiary ledger accounts which should differentiate between unrestricted and restricted funds.*

Plant Funds—Investment in Plant

Asset Accounts

Land

Buildings

Allowance for Depreciation—*credit balance account*

Improvements Other than Buildings

Allowance for Depreciation—*credit balance account*

Equipment

Allowance for Depreciation—*credit balance account*

Library Books

Art Museums and Collections

Construction in Progress—*alternatively can be shown in the Unexpended Plant Funds subgroup of Plant Funds*

Liability and Fund Balance Accounts

Accounts Payable

Notes Payable

Bonds Payable

Mortgages Payable

Leaseholds Payable

Due to Other Fund Groups

Net Investment in Plant—*detailed as needed*

Agency Funds

Asset Accounts

Cash

Accounts Receivable

Notes Receivable

Allowance for Doubtful Accounts and Notes—*credit balance account*

Investments

Due from Other Fund Groups

Liability Accounts

Accounts Payable

Due to Other Fund Groups

Deposit Liabilities—*Accounts for each agency fund should be carried either in the general ledger or in subsidiary ledgers.*

Current Funds Revenues Accounts

(Separate Restricted and Unrestricted Accounts)

Tuition and Fees—*detailed as needed*

Federal Appropriations

State Appropriations

Local Appropriations

Federal Grants and Contracts

State Grants and Contracts

Local Grants and Contracts

Private Gifts, Grants, and Contracts—*detailed as needed*

Endowment Income—*detailed as needed, for example:*

Income from Funds Held by Others Under Irrevocable Trusts

Sales and Services of Educational Activities—*detailed as needed, for example:*

Film Rentals

Testing Services

Home Economics Cafeteria

Demonstration Schools

Dairy Creameries

Food Technology Divisions

Sales and Services of Auxiliary Enterprises—*detailed as needed, for example:*

Residence Halls

Faculty Housing

Food Services

College Union

Additional revenue accounts may be established for sources of sales, types of products and services, and cash and interdepartmental sales.

Sales and Services of Hospitals—*detailed as needed, for example:*

Daily Patient Services

Nursing Services

Other Professional Services

Health Clinics *if an integral part of the hospital*

Other Sources—*detailed as needed*

Independent Operations—*detailed as needed by organization units*

Current Funds Expenditures and Transfers Accounts

Current funds expenditures accounts should bear identifying codes and symbols that will identify functions, such as Instruction, Institutional Support, and Scholarships and Fellowships; identify organizational units, such as Department of Physics, Controller's Office, and Registrar's Office; and identify the object of expenditures, such as Personnel Compensation, Supplies and Expenses, and Capital Expenditures. If desired, interdepartmental purchases, as contrasted with purchases from external sources, also may be identified by code or symbol. The object coding and symbols should be designed to provide for common usage of the objects throughout the entire chart of accounts, although, of course, there will be individual object codings that will be used only for particular functional categories.

Educational and General

Instruction

Accounts by divisions, schools, colleges, and departments of instruction following the administrative organization of the institution. The four functional subcategories are:

General academic instruction

Occupational and vocational instruction

Special session instruction

Community education

Research

Accounts by individual projects, classified by organizational units. The two functional subcategories are:

Institutes and research centers

Individual or project research

Public Service

Accounts by activities, classified by type of activity, such as:

Community Service

Conferences and Institutes

Cooperative Extension Service

Public Lectures

Radio

Television

Academic Support

Accounts by activities, classified by type of activity, such as:

Academic Administration and Personnel Development

Audiovisual Services

Computing Support *(excluding administrative data processing), unless distributed to using activities*

Course and Curriculum Development

Demonstration Schools

Libraries

Museums and Galleries

Student Services

Accounts by activities, classified by type of activity, such as:

Admissions Office

Counseling and Career Guidance

Cultural Events

Dean of Students

Financial Aid Administration

Health and Infirmary Services *if not an integral part of a hospital nor operated as an essentially self-supporting operation*

Intramural Athletics

Intercollegiate Athletics *if operated as an integral part of department of physical education and not essentially self-supporting*

Registrar

Student Organizations

Remedial Instruction

Institutional Support—*detailed as needed, for example:*

Governing Board

Chief Executive Office

Chief Academic Office

Chief Business Office

Investment Office

Legal Counsel

Administrative Data Processing

Alumni Office

Auditing, internal and external

Safety

Security

Catalogues and Bulletins

Commencements

Convocations

Development Office

Employee Personnel and Records

Fund Raising

General Insurance *other than Property Insurance*

Interest on Current Funds Loans

Legal Fees

Memberships

Printing

Provision for Doubtful Accounts and Notes

Publications

Public Relations

Purchasing

Service Departments

There should be interim accounts for all organizational units classified in this category; these accounts should be closed out at the end of each fiscal year.

Space Management

Telephone and Telegraph, *unless charged to departmental budgets*

Transportation *including motor pool, unless operated as a service department*

Operation and Maintenance of Plant

Accounts for all organizational units and functions, such as:

Administration

Custodial Services

Maintenance of Buildings

Maintenance of Grounds

Utilities

Trucking Services

Fire Protection

Property Insurance

Scholarships and Fellowships

Accounts as needed and desired for scholarships, fellowships, grants-in-aid, trainee stipends, prizes, and awards.

Tuition and Fee Remissions, *unless properly classified as staff benefit expenditures*

Accounts may be set up for instructional divisions and departments, such as:

School of Medicine

Department of Physics

Mandatory Transfers, Educational and General—*detailed to show subcategories, such as:*

Provision for Debt Service on Educational Plant

Loan Fund Matching Grants

Nonmandatory Transfers, Educational and General *(to and from)—detailed to show significant subcategories, such as:*

Loan Funds

Quasi-Endowment Funds

Appreciation on Securities of Endowment and Similar Funds

Plant Funds

Renewals and Replacements of Plant Assets

Additions to Plant Assets

Voluntary Payments on Debt Principal

Auxiliary Enterprises, Hospitals, and Independent Operations

Auxiliary Enterprises

Accounts as needed and desired for such enterprises as included in the Current Funds Revenues accounts.

Provision should be made for identification of mandatory and nonmandatory transfers—to and from—by significant subcategories.

Hospitals

Accounts as needed and desired. Provision should be made for identification of mandatory and nonmandatory transfers—to and from—by significant subcategories.

Independent Operations

Accounts as needed and desired for organizational units.

Provision should be made for identification of mandatory and nonmandatory transfers—to and from—by significant subcategories.

Classification of Expenditures by Object

The object classification of expenditures identifies that which is received in return for the expenditures. Object classification has importance as a tool for internal management, but should be considered complementary to the classification of expenditures by function and organizational unit and should not replace these classifications in the various schedules of current funds expenditures. The value of object classification will depend on the usefulness of the information it provides to management. The classifications may be omitted from published financial reports or they may be used to any degree considered desirable by the institution. The use of object classifications and the related identifying codes and symbols should not be carried to an extreme; the number of categories should be limited to those that will be of significant value to management.

Three major object classifications are found in most colleges and universities: Personnel Compensation, Supplies and Expenses, and Capital Expenditures. Breakdowns of objects within these major categories may be necessary or desirable in some situations.

Personnel Compensation

This classification includes salaries, wages, and staff benefits. In the various salary and wage expense accounts, it may be desirable to distinguish between groups of faculty and other staff members, such as full-time and part-time personnel; student and nonstudent workers; and professional, secretarial, clerical, skilled, and nonskilled employees. Appropriate code numbers and symbols within this category will aid in identifying, collecting, and summarizing information.

Supplies and Expenses

Because of their general significance to nearly all organizational units within an institution, it may be beneficial to identify significant categories of these expenditures, such as supplies, telephone, travel, and contractual services.

Capital Expenditures

The following object categories within this classification (which includes both additions to and renewals and replacements of capital assets) may prove helpful in the accounting and reporting systems of educational institutions: scientific equipment, laboratory apparatus, office machines and equipment, library books, furniture and furnishings, motor vehicles, machinery and tools, building remodeling, minor construction, and livestock.

Appendix B

Statement of Position 92-9

Audits of Not-for-Profit Organizations Receiving Federal Awards

December 28, 1992

Amendment to AICPA Audit and Accounting Guides
Audits of Providers of Health Care Services,
Audits of Voluntary Health and Welfare Organizations,
Audits of Colleges and Universities,
and *Audits of Certain Nonprofit Organizations*

Prepared by the
Not-for-Profit Organizations Committee

American Institute of
Certified Public Accountants

AICPA

NOTICE TO READERS

This Statement of Position presents the recommendations of the AICPA Not-for-Profit Organizations Committee regarding the performance of audits in accordance with generally accepted auditing standards, *Government Auditing Standards,* and OMB Circular A-133. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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SUMMARY

This statement of position (SOP) provides guidance on the auditor's responsibilities when conducting an audit in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* This SOP amends the following AICPA audit and accounting guides:

- *Audits of Providers of Health Care Services*
- *Audits of Voluntary Health and Welfare Organizations*
- *Audits of Colleges and Universities*
- *Audits of Certain Nonprofit Organizations*

In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, this SOP—

- Describes the applicability of OMB Circular A-133.
- Summarizes the differences between Circular A-133 and OMB Circular A-128, *Audits of State and Local Governments.*
- Describes the auditor's responsibility for considering the internal control structure and performing tests of compliance with certain laws and regulations.
- Describes the auditor's responsibility for reporting and provides examples of the reports required by Circular A-133.

This SOP incorporates guidance on the following:

- Statement on Auditing Standards No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance.*
- AICPA Statement of Position 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*
- The OMB's October 1991 *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions.*
- The President's Council on Integrity and Efficiency Standards Subcommittee's Position Statement No. 6 [A-133 Questions & Answers].

Chapter 1

INTRODUCTION AND OVERVIEW

Introduction

Purpose and Applicability

1.1. The purpose of this statement of position (SOP) is to provide auditors of not-for-profit organizations (NPOs) with a basic understanding of the work they should do and the reports they should issue for audits under—

a. The 1988 revision of *Government Auditing Standards* (also referred to as GAS and the Yellow Book), issued by the Comptroller General of the United States.

b. Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.*[1]

1.2. This SOP provides guidance about financial and compliance auditing requirements and requirements to consider the internal control structure promulgated by the American Institute of Certified Public Accountants (AICPA), the General Accounting Office (GAO), and the OMB; and the application of these requirements to NPOs. This SOP, instead of establishing new requirements, consolidates applicable audit requirements established by these organizations in order to facilitate efficient and effective compliance. In addition, this SOP provides guidance for implementing these requirements and includes illustrative audit reports.

1.3. This SOP is not a complete manual of procedures, nor should it supplant the auditor's judgment about the audit work required in particular situations. Because of the variety of federal, state, and local financial assistance programs and the complexity of the regulations that govern them, the procedures included in this SOP cannot cover all the circumstances or conditions that would be encountered in audits of every organization. The auditor should use professional judgment to tailor his or her procedures to meet the conditions of the particular engagement so that the audit objectives may be achieved.[2]

1.4. The provisions of this SOP are effective for audits in accordance with OMB Circular A-133 for periods ending on or after December 31, 1992. Early application of this SOP is encouraged.

Relationship of GAAS, Government Auditing Standards, *and OMB Circular A-133*

1.5. Exhibit 1 presents the relationship among the compliance testing requirements of GAAS, *Government Auditing Standards,* and OMB Circular A-133.[3] (Chapter 2 of this SOP discusses the requirements of Circular A-133.)

[1] Some of the guidance in this statement of position may be helpful for (A) program-specific audits (see paragraph 2.28) and (B) compliance testing in audits of NPOs that are performed in accordance with generally accepted auditing standards (GAAS). Paragraphs 6 through 19 of AICPA Statement on Auditing Standards No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*, describe the auditor's responsibility for testing compliance with laws and regulations in an audit conducted in accordance with GAAS. Appendix B of this SOP explains how to obtain these and other relevant publications.

[2] The auditor should refer to relevant AICPA audit and accounting guides, such as *Audits of Voluntary Health and Welfare Organizations, Audits of Colleges and Universities, Audits of Certain Nonprofit Organizations* and *Audits of Providers of Health Care Services.*

[3] OMB Circular A-133 is reprinted in appendix A of this SOP.

SAS No. 68 defines the auditor's responsibility to understand and assess audit risk related to compliance, and to design audit procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts resulting from violations of laws and regulations that have a direct and material effect on financial statement amounts in an audit of financial statements under GAAS. It also discusses the auditor's responsibility when conducting audits under *Government Auditing Standards* and OMB Circular A-133.

Exhibit 1

Auditing Compliance With Laws and Regulations

ORGANIZATION-WIDE AUDITS[4] IN ACCORDANCE WITH CIRCULAR A-133

Procedures Performed

General Requirements: Testing of compliance with general requirements applicable to federal awards

Specific Requirements:

> *Major programs:* Audit of compliance with specific requirements applicable to major federal programs
>
> *Nonmajor programs:* Testing of compliance with laws and regulations applicable to nonmajor program transactions selected in connection with the audit of the financial statements or the consideration of the internal control structure over federal awards

GOVERNMENT AUDITING STANDARDS

Procedures Performed

Same testing of compliance with laws and regulations as required by GAAS. However, GAS requires a written report on compliance with laws and regulations.

GENERALLY ACCEPTED AUDITING STANDARDS

Procedures Performed

Testing of compliance with laws and regulations in accordance with SAS No. 54, *Illegal Acts by Clients,* and SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* as described in SAS No. 68

1.6. Exhibit *2* presents the relationship among the requirements to consider the internal control structure under GAAS, *Government Auditing Standards,* and OMB Circular A-133. SAS No. 68 distinguishes the requirements of reporting on the internal control structure under GAAS and *Government Auditing Standards.* Guidance on the additional internal control structure testing requirements of OMB Circular A-133 is in chapter 5 of this SOP.

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[4] Audits performed in accordance with Circular A-133 are often referred to as organization-wide audits.

Exhibit 2

Consideration of the Internal Control Structure

ORGANIZATION-WIDE AUDITS IN ACCORDANCE WITH CIRCULAR A-133

Procedures Performed

Testing of control policies and procedures in the internal control structure over federal awards

Reporting

Requires a report on the internal control structure used in administering federal awards

GOVERNMENT AUDITING STANDARDS

Procedures Performed

The same procedures as required by GAAS

Reporting

Requires a written report on the auditor's understanding of the internal control structure over financial reporting and assessment of control risk under SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.* Also requires the identification of the internal control structure categories considered and separate identification of those reportable conditions that are significant enough to be material weaknesses.

GENERALLY ACCEPTED AUDITING STANDARDS

Procedures Performed

Obtaining an understanding of the internal control structure over financial reporting sufficient to plan the audit and assess control risk in accordance with SAS No. 55

CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN A FINANCIAL STATEMENT AUDIT

Reporting

Requires an oral or written report when reportable conditions are noted in accordance with SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*

1.7. *Government Auditing Standards* should be followed when required by law, regulation, agreement or contract, or policy. In performing audits in accordance with *Government Auditing Standards,*[5] the auditor assumes certain reporting responsibilities beyond those of audits performed in accordance with GAAS.[6] Thus, *Government Auditing Standards* incorporates fieldwork and reporting under GAAS and expands upon certain reporting requirements of GAAS. The additional reporting responsibilities focus on compliance with laws and regulations and the internal control structure over financial reporting. In addition to requirements for written reports on compliance and the internal control structure over financial reporting in all audits, *Government Auditing Standards* includes quality-control, continuing professional education, specific working-paper, and audit follow-up requirements.

Nature and Purpose of an Organization-Wide Audit

1.8. America's hundreds of thousands of NPOs receive billions of dollars of financial assistance every year. The sources of this funding include both governmental and private entities. Much of this funding—even matching support for general program purposes—is given subject to an NPO's compliance with certain laws and regulations. In the past, each sponsor audited its individual program to determine whether the NPO had complied with the applicable laws and regulations. Such compliance audits proliferated, however, and grantees were often tied up for weeks with many sets of auditors. In the late 1970s, the federal government began to develop the single-audit concept. In accordance with this concept, one auditor, most often the independent auditor, would integrate the various sponsors' compliance auditing requirements and their requirements to consider the organization's internal control structure with an audit of the financial statements.

1.9. The single-audit concept became United States law for state and local governmental grantees with the enactment of the Single Audit Act of 1984. (For a more detailed history of key events in the history of auditing federal programs, see SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance.*) Circular A-128 is the policy that implements the Single Audit Act. Circular A-133,[7] which was patterned after Circular A-128, was issued in 1990. Both Circulars A-128 and A-133 provide

[5] *Government Auditing Standards* includes standards for financial audits as well as for performance audits. The references to *Government Auditing Standards* in this SOP encompass only the standards for financial audits and not the performance audit standards. However, *Government Auditing Standards* states that the "report 'Contents' and 'Presentation' standards, which are included in the section describing performance audit reporting standards, also apply for financial audits."

[6] Paragraphs 4 and 5 of SAS No. 68 describe the auditor's responsibility when he or she has been engaged to perform an audit in accordance with GAAS and becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. In such a situation, SAS No. 68 requires that the auditor communicate to management and the audit committee, or to others with equivalent authority or responsibility, that an audit in accordance with GAAS alone will not satisfy the relevant legal, regulatory, or contractual requirements. That communication may be oral or written. However, if the communication is oral, the auditor should document that in the audit workpapers. The auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions in relation to the guidance in SAS No. 54.

[7] The audit requirements of Circular A-133 supersede those for certain entities described in attachment F, subparagraph 2h, of Circular A-110, *Uniform Administrative Requirements—Grants and Agreements with Institutions of Higher Education, Hospitals and Other Nonprofit Organizations.* Institutions subject to Circular A-110 should continue to follow the audit provisions of attachment F to Circular A-110 either until the institutions implement Circular A-133 or (in the case of organizations that are not subject to Circular A-133) as a matter of course. It should be noted that other requirements of A-110 discussed in paragraph 1.27 of this SOP remain in effect for all nonprofit grantees.

guidance on implementing the single-audit concept, although the Single Audit Act itself does not apply to NPOs. Rather, the single-audit concept is described in Circular A-133 as an "organization-wide audit."

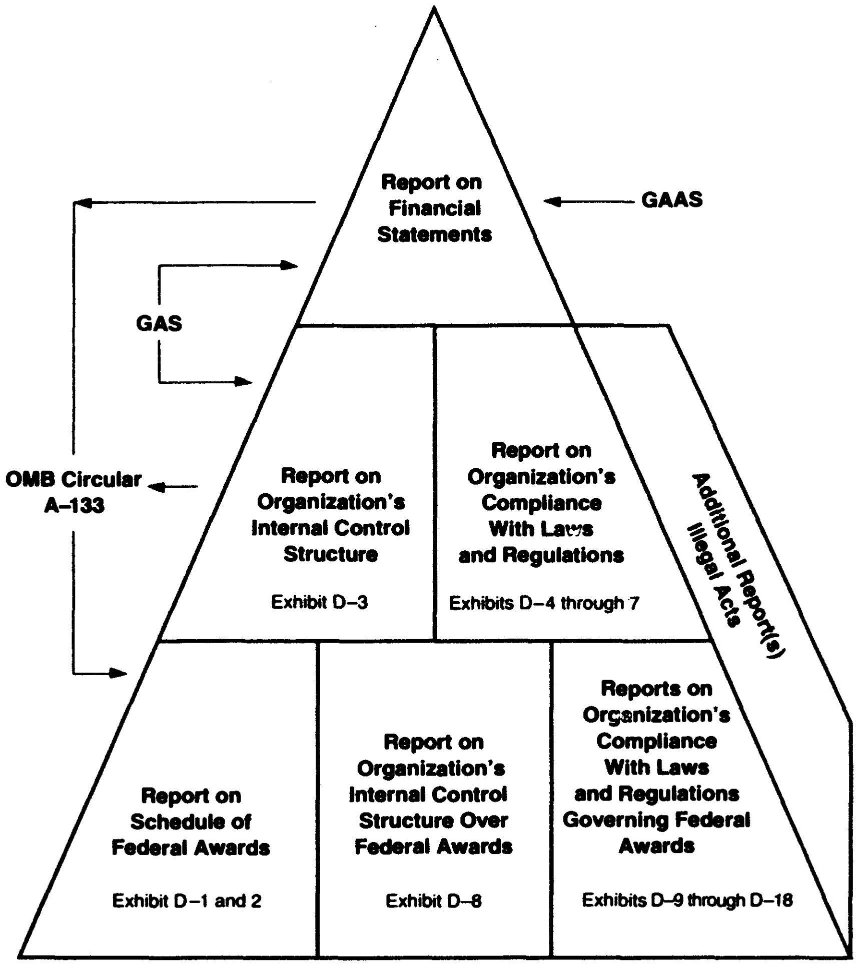
Components of an Organization-Wide Audit

1.10. With certain exceptions, NPOs that receive over $25,000 per year in federal awards are subject to Circular A-133.[8] NPOs receiving less than $25,000 per year in federal awards are exempt from federal audit requirements, but records are to be available for review by appropriate officials of the granting entity or subgranting entity. An organization-wide audit under Circular A-133 has two main components—an audit of the financial statements (paragraph 1.11 of this SOP) and an audit of federal awards (paragraphs 1.12 and 1.13 of this SOP). Each component results in a variety of audit reports. An overview of the various reports issued in an organization-wide audit is presented in exhibit 3.

[8] Organizations receiving awards of $100,000 or more under only one program have the option of having a program-specific audit. Organizations receiving total awards of at least $25,000 but not more than $100,000 per year have the option of having an audit performed in accordance with Circular A-133 or having an audit made of each award. Paragraphs 2.28 through 2.35 of this SOP provide guidance on program-specific audits.

Exhibit 3

Levels of Reporting in Organization-Wide Audits



1.11. *Financial Statement Audit.* The financial statement audit required by Circular A-133 is performed in accordance with GAAS and GAS, and results in reports on the financial statements, compliance, and the internal control structure over financial reporting. The primary sources of guidance and standards regarding the auditing of the financial statements of NPOs are the AICPA Statements on Auditing Standards, particularly SAS No. 68; *Government Auditing Standards;* and the AICPA audit and accounting guides *Audits of Voluntary Health and Welfare Organizations, Audits of Colleges and Universities, Audits of Certain Nonprofit Organizations,* and *Audits of Providers of Health Care Services.*

1.12. *Audit of Federal Awards.* In performing an audit in accordance with Circular A-133, the auditor assumes certain testing and reporting responsibilities beyond those of an audit performed in accordance with GAAS and GAS. Thus, an audit in accordance with Circular A-133 incorporates GAAS and GAS and expands on certain of their testing and reporting requirements. The additional responsibilities focus on compliance with laws and regulations applicable to federal awards and on the internal control structure over federal awards. The terms *single audit, organization-wide audit,* and *entity-wide audit* are frequently used interchangeably by practitioners when they refer to the more extensive form of an audit of federal awards required by Circular A-133.

1.13. The audit of federal awards specified in Circular A-133 provides a basis for issuing additional reports on the internal control structure and on compliance. The remainder of this chapter introduces concepts that are important to establishing the scope of an audit of federal awards, summarizes the auditor's responsibilities in such an audit, and previews the other sections of this SOP.

Determining the Scope of an Audit of Federal Awards

1.14. Two factors, the relative size of federal award programs and the compliance requirements applicable to these programs, determine the scope of the auditor's work and the reports to be issued in an audit of federal awards under Circular A-133.

1.15. *Size—Major versus Nonmajor Programs.* Before an audit begins, the NPO should identify the programs under which it receives federal awards, to prepare the required schedule of federal awards (see chapter 4 of this SOP) and to identify which programs are "major" and which programs are "nonmajor" for audit purposes. For purposes of Circular A-133, a program is an award or group of awards for a similar purpose or general line of inquiry. Federal sponsors have classified awards into program categories in the *Catalog of Federal Domestic Assistance* (CFDA), published by the Government Printing Office. However, the CFDA may not include all programs. For example, contracts and foreign assistance programs may not be listed in the CFDA. In general, awards that are assigned the same CFDA number constitute a program. The President's Council on Integrity and Efficiency (PCIE) Standards Subcommittee's Position Statement No. 6, Question 24, states that "an exception to the statement that all awards under the same CFDA number constitute a program is when a State government combines different Federal awards into a combined program which is passed through to a not-for-profit recipient. In this case, the State government *may* require the subrecipient to treat the combined program as a single program for both major program determination and to determine whether a program-specific audit may be elected . . ." In addition, single-program treatment is appropriate under Circular A-133. However, Circular A-133 specifies that awards in two defined categories—student financial assistance and research and development—be classified as separate programs.

1.16. PCIE Position Statement No. 6, Question 24, also states that "for awards not assigned a CFDA number, all awards made for the same purpose would be combined as one program similar to how grants under the same CFDA number from multiple funding years are combined as one program." For example, if funds were expended during the audit period from both an original agreement and a separate award that renewed the original agreement, the two awards would be combined and considered as one program.

1.17. PCIE Position Statement No. 6, Question 40, states that, if the CFDA numbers are not available for awards, the NPO should include the awarding agency name and program name or some other identifier obtained from the award documents in the Schedule of Federal Awards.

1.18. The type of reports issued and, therefore, the audit work required in an audit performed in accordance with Circular A-133 depend on whether financial awards received by the NPO constitute major or nonmajor programs. Circular A-133 states that each of the following categories constitutes a major program if total federal expenditures are the larger of 3 percent of total federal funds expended or $100,000:

a. Research and development

b. Student financial aid

c. Individual programs not in the research-and-development or student financial-aid category

1.19. Any federal program without sufficient expenditures to be considered a major program is a nonmajor program. As will be discussed, the auditor's responsibilities for major programs generally are greater than those for nonmajor programs.

1.20. *Compliance Requirements.* Paragraph 13(c)(1) of Circular A-133 requires that "[t]he auditor shall determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major federal programs." The term *compliance requirements* refers to the laws, regulations, and other requirements that an auditor should consider in making this determination.

1.21. The principal compliance requirements and suggested audit procedures for the largest federal programs are included in the *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* (Circular A-133 Compliance Supplement), issued by the OMB and available from the Government Printing Office. For testing general requirements (see paragraph 1.26 of this SOP), the auditor should follow the guidance contained in the Circular A-133 Compliance Supplement. For testing specific requirements (see paragraph 1.24 of this SOP), the auditor should follow the guidance provided for that program, which may be included in either the Circular A-133 Compliance Supplement or the *Compliance Supplement for Single Audits of State and Local Governments.* For programs not listed in the compliance supplements, compliance requirements may be determined by researching the statutes, regulations, grant agreements governing individual programs or the *Catalog of Federal Domestic Assistance.* Additionally, some agencies have developed audit guides for programs not included in the Compliance Supplement. This guidance, where applicable, may be obtained from the Office of the Inspector General of the appropriate federal agency.

1.22. The auditor should be aware that compliance requirements may change over time. Thus, the auditor should also review grant agreements to determine whether specific requirements reflected in the Compliance Supplements have changed. If there have been changes, the auditor should follow the provisions of the Compliance Supplement as modified by the changes.

1.23. Paragraphs 13(c)(4) and (5) of Circular A-133 list the compliance requirements on which the auditor should express an opinion. Some of these requirements (e.g., federal financial reports and allowability of expenses) are listed as "general" requirements in the OMB Compliance Supplements; others (e.g., matching and level of effort) are set forth as "specific" requirements of each of the various programs described in the Compliance Supplements.

1.24. *Specific Requirements.* These requirements include—

- *Types of services allowed or not allowed,* which specifies the types of goods or services that entities may purchase with financial assistance and the types of costs that may be claimed.
- *Eligibility,* which specifies the characteristics of individuals or groups to whom entities may give financial assistance.
- *Matching, level of effort, or earmarking,* which specifies amounts entities should contribute from their own resources toward projects for which financial assistance is provided.
- *Reporting,* which specifies reports that entities must file in addition to those required by the general requirements.
- *Special tests and provisions,* which identifies other provisions for which federal agencies have determined that noncompliance could materially affect the program. (For example, some programs specify limits on salaries paid under research grants; other programs prohibit the use of foreign carriers for overseas travel; still other programs set a deadline for the expenditure of federal awards.)

The auditor should note that the following are also considered to be specific requirements:

- Federal financial reports and claims for advances and reimbursements include information that is supported by books and records from which the basic financial statements have been prepared.
- Amounts claimed for reimbursement or used for matching were determined in accordance with the cost principles and matching or cost-sharing requirements set forth in (*a*) OMB Circular A-21, *Cost Principles for Educational Institutions;* (*b*) OMB Circular A-110, *Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations;* (*c*) OMB Circular A-122, *Cost Principles for Nonprofit Organizations;* (*d*) Federal Acquisition Requirements, subpart 31, cost principles; and (*e*) other applicable cost principles or regulations.

These two requirements—federal financial reports and allowable costs—are considered both general and specific by OMB. Thus, the same audit procedures can be used to test compliance with those requirements.

1.25. Although the auditor should test compliance with the requirements specified in the Compliance Supplements, performance of the suggested audit procedures is not mandatory. However, federal Inspectors General recommend their use. The auditor may refer to the statute or Code of Federal Regulations (CFR) identified in the appropriate Compliance Supplement to obtain a complete understanding of the compliance requirements. The auditor may also review award documents and procedure manuals to gain familiarity with the federal compliance requirements. The auditor may also contact the appropriate Inspectors General office, grantor, or agency to determine the availability of agency-prepared supplements or audit guides for programs not included in the Compliance Supplements.

1.26. *General Requirements.* In addition to the specific requirements, the Circular A-133 Compliance Supplement also identifies eight general compliance requirements that apply to all federal award programs. These requirements are:

- Political activity (Hatch Act and Intergovernmental Personnel Act of 1970, as amended)
- Construction contracts (Davis-Bacon Act)
- Civil rights
- Cash management
- Federal financial reports
- Drug-free workplace[9]
- Allowable costs and cost principles
- Administrative requirements (Circular A-110)

1.27. Three administrative requirements set forth in Circular A-110—those regarding cash management, financial reporting, and cost principles—are explicitly included among the general requirements. Other administrative requirements included in the Compliance Supplement affect the following matters:

- Interest earned on advances
- Period of availability of funds
- Program income
- Real property
- Equipment
- Supplies
- Subawards to debarred and suspended parties
- Procurement
- Subawards
- Revolving fund repayments

The Circular A-133 Compliance Supplement sets forth audit procedures for testing compliance with three of these requirements: program income, property management, and procurement. The auditor should exercise professional judgment in determining appropriate audit procedures for testing compliance with the other requirements and whether there are other administrative requirements that are relevant in an organization-wide audit of federal awards of an NPO.

1.28. The auditor should perform tests of compliance for all of the general requirements applicable to federal awards. Thus, the auditor should test and report on compliance with general requirements regardless of whether or not the NPO being audited has major programs. SAS No. 68 states that it has become generally accepted that the nature of the procedures suggested in the compliance supplements is sufficient to satisfy the requirements of Circular

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[9] Per PCIE Position Statement No. 6, Question 68, the Drug-Free Workplace Act applies to recipients who receive grants directly from federal agencies. The Drug-Free Workplace Act does not apply to subrecipients. However, if a subrecipient is also a prime recipient, the auditor must test for compliance with the Drug-Free Workplace Act. Also, in some cases the prime recipient may by contract pass the Drug-Free Workplace requirements on to a subrecipient.

A-133 with respect to the general requirements. However, the Compliance Supplement does not specify the extent of such procedures. The auditor should exercise professional judgment in determining the extent of compliance testing of general requirements. Additionally, the auditor should evaluate his or her understanding and assessment of the internal control policies and procedures used in administering programs, and should exercise professional judgment in determining the extent of procedures for testing compliance with the general requirements. Typically, many of these procedures would be performed in conjunction with tests of controls over federal awards.

The Auditor's Responsibilities in Audits of Federal Awards—An Overview

1.29. The extent of the auditor's tests of internal control structure policies and procedures used in administering federal awards and the organization's compliance with laws and regulations is determined by the size of federal award programs and the compliance requirements applicable to them. The following sections briefly describe how program size and compliance requirements determine the scope of each component of the audit of federal awards.

The Internal Control Structure Used in Administering Federal Awards

1.30. In audits of federal awards conducted as part of an organization-wide audit in accordance with Circular A-133, the auditor is concerned with the design and operation of the internal control structure policies and procedures relevant to ensuring compliance with both specific and general requirements. The auditor's work in this area is in addition to the consideration of the internal control structure—specifically, obtaining an understanding of the structure and assessing control risk—that is a part of a financial statement audit.

1.31. For all major programs, the auditor should document this understanding and assessment, and he or she should test the operating effectiveness of the design and operation of the internal control structure policies and procedures ("test controls") relevant to ensuring compliance with both general and specific requirements. Evidence gained from tests of controls relevant to compliance with specific requirements would likely provide evidence that the auditor could use to determine the nature and extent of testing required to express an opinion on compliance with specific requirements applicable to major programs.

1.32. If the total amount of major program expenditures represents less than half of total federal expenditures, or if there are no major program expenditures, the auditor should gain an understanding, assess control risk, and perform a test of controls of the internal control structure for nonmajor programs, until such procedures (including those performed on major programs) encompass programs constituting 50 percent of total federal expenditures. The auditor may select nonmajor programs on a rotating basis so that the control structure over all programs is understood, assessed, and tested over a number of years. The PCIE suggests that these procedures be performed at least once every three years. An alternative to selecting nonmajor programs on a rotating basis (to reach 50 percent of total federal expenditures) is to test controls over the largest nonmajor programs, starting with the largest, until at least half of the total federal expenditures have been subjected to tests of controls.

1.33. With regard to the internal control structure of the remaining nonmajor programs, the auditor should understand the related internal control structure and determine that the controls are in place. The auditor may achieve this understanding and determination on a cyclical basis. In the first year, the auditor should gain an understanding of internal controls and assess risk for all but clearly insignificant nonmajor programs. This process may include inquiries, observations or walk-throughs. Thereafter, the auditor would obtain an understanding of internal controls and assess control risk for all but clearly insignificant nonmajor programs once every three years. Any new nonmajor programs, other than those that are clearly insignificant, should be reviewed the first year the program is active. If two-year (biennial) audits are performed, all programs should be covered by every second audit.

Compliance With Laws and Regulations

1.34. The interaction between the relative size of the federal awards program and the type of applicable compliance requirements results in three distinct levels of responsibility for testing and reporting on compliance with laws and regulations in an audit of federal awards. Chapter 6 of this SOP discusses these responsibilities. Chapters 6 and 7 discuss the schedule of findings and questioned costs.

1.35. *Failure to Follow Standards.* The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits,* states that when an auditor undertakes an audit of government grants or recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he or she is obligated to follow these standards or guidelines in addition to GAAS. Failure to do so is an act discreditable to the profession and a violation of rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that these rules were not followed and the reasons are given.

1.36. *Overview of This SOP.* Chapter 2 of this SOP discusses the requirements of Circular A-133. Chapter 3 discusses planning the organization-wide audit. Chapter 4 describes the Schedule of Federal Awards. Chapter 5 describes the auditor's consideration of the internal control structure in audits performed in accordance with *Government Auditing Standards* and in those performed in accordance with Circular A-133. Chapter 6 discusses compliance auditing requirements. Chapter 7 discusses reporting considerations.

Chapter 2

REQUIREMENTS OF OMB CIRCULAR A-133

Applicability

2.1. The applicability of OMB Circular A-133 to an NPO depends on (*a*) the status of its adoption by individual federal and other sponsors, (*b*) the type of NPO, and (*c*) the amount of federal awards it receives.

Status of Adoption

2.2. Circular A-133 is directed to federal agencies with an effective date for fiscal years beginning on or after January 1, 1990. Federal agencies may implement Circular A-133 by regulation or contract. The effective date of implementation by the federal grantor agency will determine the effective date for the recipient.

2.3. As of the date of this SOP, most major federal agencies have taken steps to implement Circular A-133, either by incorporating it into the Code of Federal Regulations or by issuing internal policy directives and instructions to grantees.

2.4. Nine federal agencies (the departments of Commerce, Defense, Education, Energy, Health and Human Services, Housing and Urban Development, the Interior, Labor, and the Environmental Protection Agency) have issued final regulations to formally implement Circular A-133. The Department of Agriculture is actively working to finalize regulations to incorporate Circular A-133.

2.5. Other smaller federal agencies have chosen to implement Circular A-133 by issuing internal directives and amending grant administration handbooks and individual award agreements. Agencies using this approach include the Federal Emergency Management Agency, the National Science Foundation, the National Endowments for the Arts and Humanities, the Agency for International Development (AID), ACTION, and the Departments of Justice and Transportation.

2.6. In some cases, states or other recipients have implemented Circular A-133 for their subrecipients under federal awards or for programs funded by their own appropriations.

2.7. Question 2 of PCIE Position Statement No. 6 states that if a not-for-profit organization receives federal awards from two federal agencies, one that has implemented Circular A-133 in regulation and one that has not, the "not-for-profit should have an audit in accordance with [Circular] A-133 and include the federal awards from both agencies. An audit done in accordance with Circular A-133 will meet the requirements of A-110."

Type of NPO

2.8. Circular A-133 defines a not-for-profit institution as any corporation, trust, association, cooperative, or other organization that—

a. Is operated in the public interest primarily for scientific, educational, service, charitable, or similar purposes.

b. Is not organized primarily for profit.

c. Uses its net proceeds to maintain, improve, or expand its operations.

2.9. Accordingly, the NPOs covered by Circular A-133 include colleges and universities (and their affiliated hospitals [10] and community-based organizations such as voluntary health and welfare organizations). Circular A-133 does not apply to—

- Colleges and universities covered by Circular A-128. According to paragraph 6c of OMB Circular A-128, a state or local government can elect to include institutions of higher education in its Circular A-128 audit. State and local government institutions of higher education excluded from the government's Circular A-128 audit can be audited separately under Circular A-128 or Circular A-133.
- Hospitals not affiliated with a college or university.[11]
- State and local governments and Indian tribes covered by Circular A-128.

2.10. Except for the public hospitals and universities cited above, Circular A-128 does not apply to NPOs. Before the promulgation of Circular A-133, however, it was not uncommon for state and local government recipients to contractually require Circular A-128 audits of their not-for-profit subrecipients.[12] With the promulgation of Circular A-133, an organization will no longer need an audit in accordance with Circular A-128 and one in accordance with Circular A-133. The subrecipient should clarify the matter with the recipient requiring an A-128 audit. In most cases, the contract can be changed to specify a Circular A-133 audit. Not-for-profit organizations with new contracts should consider making reference to Circular A-133 audit requirements in such contracts.

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[10] According to 42 Code of Federal Regulations (CFR) Ch. IV (10-1-91 Edition), Part 409—Hospital Insurance Benefits, Section 409.3 (Definitions), a hospital is a facility that meets the following criteria:

— Is primarily engaged in providing by or under the supervision of doctors of medicine or osteopathy, inpatient services for the diagnosis, treatment, and care or rehabilitation of persons who are sick, injured, or disabled;

— Is *not* primarily engaged in providing skilled nursing care and related services for inpatients who require medical or nursing care;

— Provides 24-hour nursing service; and

— Is licensed or approved as meeting the standards for licensing by the State or local licensing agency as a hospital.

[11] Hospitals (e.g., community hospitals) not affiliated with a college or university that are subject to OMB Circular A-110's audit requirement, are subject to statutory audit requirements of Medicaid, Medicare, or other programs in which they participate.
Circular A-133 applies to hospitals "affiliated" with an institution of higher education but not audited as part of a state or local government under Circular A-128. Since Circular A-133 does not define affiliated, the Department of Health and Human Services (HHS) has developed a definition to include hospitals with significant research and training funds. The HHS definition (HHS interim final rule, published *Federal Register,* Friday, March 1, 1991, starting at page 8712) of affiliated includes all situations where—

— Either a hospital or an institution of higher education has an ownership interest in the other entity, or some other party (other than a state or local unit of government) has an ownership interest in each of them

— An affiliation agreement exists

— Federal research or training awards to a hospital or institution of higher education are performed in whole or in part in the facilities of, or involve the staff of, the other entity.

[12] Paragraphs 3.20-3.41 of this SOP discuss the responsibilities of the recipient and subrecipient and their auditors.

Amount of Federal Awards

2.11. OMB Circular A-133 applies to NPOs that directly or indirectly receive federal awards above a certain threshold, as discussed in paragraph 1.10. The term *federal awards* is defined broadly in Circular A-133 to include federal financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. *Federal financial assistance* is defined as assistance provided by a federal agency to a recipient or subrecipient in the form of grants, contracts, loans, cooperative agreements, loan guarantees, property, interest subsidies, insurance, direct appropriations, and other noncash assistance. For purposes of determining the amount of federal awards, loans and guarantees are afforded a specific treatment.

2.12. The following guidelines should be used to calculate the value of assistance expended under loan or loan guarantee programs for determining major programs:

Types of Noncash Assistance	*Basis Used to Determine Major Programs*
Loans (including guaranteed student loans made by an institution of higher education and loan guarantees)	Value of new loans processed during the fiscal year, plus the balance of loans made in the prior years for which the federal government is at risk, plus any interest subsidy, cash, or administrative cost allowance received
Commodities	Value of the commodities issued during the year
Insurance	Value of the insurance contract
Guaranteed student loans that were not made by an institution of higher education	Value of the guaranteed loans made during the year
Food stamps	Value of food stamps distributed during the year

Note: Value as used in this table is to be determined by methods or prices prescribed by the federal departments making the award.

2.13. At institutions of higher education and other organizations having student financial assistance (SFA) programs, the value of guaranteed student loans processed during the year, if available, is considered as an expenditure for major program determination. Guaranteed student loans are then combined with other student financial assistance to form the category of SFA. The SFA category total is then compared to the larger of 3 percent of total federal funds expended or $100,000 to determine whether SFA is a major program.

2.14. When determining major programs, the inclusion of noncash programs should not result in the exclusion of other programs from the definition of major programs. PCIE Position Statement No. 6, Question 26, provides guidance for inclusion of loan and loan guarantee programs in the determination of major programs as follows: "When including a loan program significantly affects the number or size of other major programs, the loan program should be considered a major program, and the value attributed to the loan program should be excluded in determining other major programs."

2.15. An organization may receive program assistance in various forms. The classification of cash-supported programs as major or nonmajor depends, as shown in the following table, on whether or not the noncash programs (i.e., commodities and loans) are considered to be part of the entity's total federal awards when the 3 percent test is applied:

Program/Federal Grantor	*Federal Awards Received*
Cash Program A—Labor	$ 1,335,000
Cash Program B—DHHS	3,000,000
Cash Program C-1—Education	175,000
Cash Program C-2—Education	280,000
Cash Program D-HUD (subaward from county)	310,000
Subtotal Cash Expenditures	5,100,000
Commodities Program E—U.S. Dept. of Agriculture (subaward from state)	2,000,000
Subtotal—expenditures—cash and commodities	7,100,000
Loan Program F—Perkins	3,500,000*
Loan Guarantee Program G—HUD	7,000,000*
Total Federal Awards Expenditures	$17,600,000

DHHS = Department of Health and Human Services; HUD = Department of Housing and Urban Development; USDA = United States Department of Agriculture; FFA = Federal Financial Assistance.

* Total of new loans made during the year plus prior-year loans for which the federal government is at risk.

- Major programs are based on the larger of (*a*) 3 percent of $7,100,000 or $213,000 (total cash and noncash federal awards, except for loans and loan guarantees) or (*b*) $100,000. Major programs are those in excess of the higher of these figures, or $213,000.
- Therefore, according to Circular A-133, all programs above, except Program C-1, are major, *including* Programs F and G.
- Programs F and G do *not* count in the total for the test. If Programs F and G were included, major programs would be 3 percent of $17,600,000 or $528,000, making Programs C-1, C-2, and D *nonmajor.*

2.16. Once management has prepared the schedule of federal awards and identified each major program, the auditor should assess the reasonableness and completeness of the schedule, as well as management's determination of major programs.

2.17. Federal awards shown on the schedule should include pass-through assistance (subawards of federal assistance from nonfederal sponsors) but should not include direct federal cash assistance to individuals.[13]

[13] Medicare funds paid to a not-for-profit provider for health care services to Medicare-eligible individuals are not considered to be federal financial awards subject to Circular A-133 audits.
Medicaid funds paid to a not-for-profit provider of health care services under a fixed-price arrangement generally are not subject to Circular A-133 audits.
However, under certain circumstances, Medicaid funds may be subject to Circular A-133 audits. The following are the most likely circumstances:

- Because state and local funds are also part of the Medicaid program, the state may require the NPO to have an audit in accordance with Circular A-133 (or any other requirements) and/or may require expanded coverage for a number of reasons.

Receipts

2.18. Question 7 of PCIE Position Statement No. 6 states that the definition of a receipt, which determines which entities are subject to Circular A-133, is based on how a recipient recognizes and reports its revenue. It states that "receipt of an award is *not* tied to when the contract or grant agreement is signed or awarded to the NPO." Generally, a recipient has received awards when it has obtained cash or noncash assistance, or when it has incurred expenditures that will be reimbursed under a federal program. Receipt of federal awards occurs when revenues are recorded in the financial statements.

2.19. For programs that involve the receipt of tangible assets (such as food stamps, food commodities, and donated surplus property), "receipts" should be based on the point at which the revenue is recognized according to generally accepted accounting principles. For programs that do not involve the transfer of tangible assets (such as guarantee and insurance programs), "receives" should be based on the transaction or event that gives rise to the award.

2.20. Determining the year in which an award is received is particularly important when an NPO is not required to have an audit each year. For example, an NPO may meet the dollar threshold requiring an audit in one year, but not in the next. In this case, the fiscal year audited should match the fiscal year in which the related award activity (expenditures or noncash transactions) occurs.

2.21. The following table sets forth the requirements of Circular A-133 for the types of NPOs described in paragraphs 2.8 and 2.9 of this SOP, based on the amount of awards received.

What Is the Total Amount of Federal Awards Received in a Year?	*Is the Organization Required to Follow Circular A-133?*
$100,000 or more	Yes. However, if the awards are under only one program, the organization has the option of following Circular A-133 or having an audit of the program based on the requirements governing the program in which the organization participates (see paragraph 2a(2) of the Attachment to A-133).
At least $25,000, but less than $100,000	The organization has the option of following Circular A-133 or having an audit of each award based on that program's requirements. The requirements for individual program audits are set forth in the respective regulations and audit guides (see appendix B of this SOP).
Less than $25,000	No. However, records must be available for review by appropriate officials.

(Footnote Continued)

- When Medicaid funds are paid to an NPO to assist the state or local government in administering the Medicaid program, a Circular A-133 organization-wide or program-specific audit would be required. The following are examples:

—The state contracts with a not-for-profit peer review organization to administer the Medicaid utilization review function.

—The state contracts with an NPO to handle the claims-processing function.

2.22. PCIE Position Statement No. 6, Question 29, states that noncash assistance such as free rent, interest subsidy, food stamps, food commodities, Women/Infant/Children (WIC) program vouchers, or donated property should be valued at fair market value at the time of receipt to determine the amount of federal award. WIC program vouchers may be valued either at maximum allowed redemption value or average redeemed value.

2.23. PCIE Position Statement No. 6 states that receipt of *only* free rent would not be considered a federal award to carry out a program and therefore would not require an audit under Circular A-133. However, the not-for-profit may be subject to monitoring, audit, or other requirements imposed by the federal agency providing free rent.

2.24. In some cases, the free rent may be received as part of a federal award or other assistance to "carry out a program." In these cases, the free rent would fall under the definition of "other noncash assistance" and would be included in the total amount awarded for the program, under Circular A-133, paragraph 1e(1).

2.25. PCIE Position Statement No. 6, Question 12, states that nonfederal matching is not considered a federal award when determining whether or not an audit is required. For example, a $25,000 match to a $75,000 Federal award would not be considered federal financial assistance; only the $75,000 would be added to any other federal awards to determine whether an audit is required. Once it is determined that an audit is required, however, the auditor should consider whether it is necessary to apply any tests of compliance with requirements applicable to the matching funds.

Treatment of Loans

2.26. PCIE Position Statement No. 6, Question 7, states that, "since the federal government is at risk for loans and loan guarantees, ("Loans") until the debt is repaid, the balance of prior year loans is considered current year financial assistance in each year they are outstanding." PCIE Question 6 notes that if the only federal assistance is prior year loans, then the NPO may have an audit in accordance with the laws and regulations governing the Loans, according to paragraph 2a(1) of the Attachment to Circular A-133.

2.27. Further, PCIE Question 6 states: "however, the Loans may be one time financing with no continuing audit or other compliance requirements except to make repayment. In cases such as this, when the only Federal awards are Loans and the Federal agencies providing the loans do not require an audit, then Circular A-133 would not require an audit."

Program-Specific Audits

2.28. There are instances where recipients may elect to have a program-specific audit rather than an audit based on the organization-wide requirements of Circular A-133 based on the option described in paragraph 2.21 of this SOP. A program-specific audit is an audit of one federal program in accordance with federal laws, regulations, or audit guides relative to that particular program and does not require a financial statement audit of the not-for-profit entity. By comparison, a Circular A-133 audit is an organization-wide audit that covers all federal awards and requires an audit of the financial statements of the not-for-profit entity. In general, in meeting program-specific requirements, the audit would follow GAS and any specific requirements set forth in the applicable regulations and related audit guides issued by the federal sponsor.

2.29. In many cases, a program-specific audit guide will be available to provide guidance on compliance testing, other audit procedures, and reporting. When engaged to conduct a program-specific audit, the auditor should obtain an understanding of the audit requirements for that particular program from the agreement with the grantor agency, from an audit guide published by the grantor agency, or through contact with the grantor agency. The PCIE Standards Subcommittee has prepared a *Program Audit Guide Survey* (October 1991), which is referred to in appendix B of this SOP. Paragraphs 7.51 through 7.54 of this SOP discuss program audit reporting.

2.30. PCIE Position Statement No. 6, Question 22 requires that program-specific audits for which no current federal agency guide is available should follow the standards for financial audits in GAS. The reporting should normally include an opinion on the financial statements of the program, a report on the internal controls over the program, and a report on program compliance with laws and regulations. A schedule of findings and questioned costs, a management letter, or a report on illegal acts may also be required when applicable.

2.31. PCIE Position Statement No. 6, Question 23, states that—

> When a current program-specific audit guide is not available, the auditor should use the following guidance for general and specific compliance requirements:
>
> > *General Requirements.* The general requirements listed in the *Compliance Supplements* should be included as part of every audit that involves Federal financial assistance. The auditor should review the Circular A-133 *Compliance Supplement* general requirements and consider these in planning the audit. In particular, federal financial reporting, cash management, allowable costs/cost principles, and administrative requirements will usually apply to all programs.
> >
> > *Specific Requirements.* The specific requirements may be obtained from the compliance supplements, program laws and regulations, or from the sponsoring agency. The auditor may also look to the *Compliance Supplements* or other sources for guidance on suggested audit procedures and the types of compliance requirements to be tested.

Program-Specific Audits—R&D

2.32. The sum of expenditures from awards for research and development (as defined in Circular A-133) received is considered a program and the sum of expenditures from SFA awards is considered a program. Under a Circular A-133 audit, expenditures for all R&D awards are tested as if they were a single program with possible different compliance requirements within the program. SFA is treated similarly.

2.33. A Circular A-133 organization-wide audit is required when there are multiple R&D awards totaling $100,000 or more. A program-specific audit is not acceptable for multiple R&D awards because R&D can be received from many federal agencies and R&D often involves multiple offices or accounting systems within the NPO.

2.34. An exception is that a program-specific audit of R&D is permitted when *all* of the following conditions are met:

a. There are only R&D awards and all awards are received from a single federal agency, or from a single prime recipient, in the case of a subrecipient.

b. The federal agency, or prime recipient in the case of a subrecipient, approves a program audit in advance. The approval should be based upon a determination that the program audit will provide at least the same level of audit coverage over federal funds as the Circular A-133 single audit.

c. The program audit is performed in accordance with *Government Auditing Standards* and guidance provided by the federal agency, or by the prime recipient in the case of a subrecipient.

Program-Specific Audits—SFA

2.35. The U.S. Department of Education (ED) and U.S. Department of Health and Human Services (HHS) have agreed to accept an SFA program audit when there are multiple awards but the awards are for SFA. The auditor may consider using the current ED audit guide, *Audits of Student Financial Assistance Programs,* which may be supplemented as necessary with the program requirements for SFA programs of other federal agencies. For purposes of an audit conducted in accordance with Circular A-133, all SFA programs are considered to be a single major program, while the ED audit guide requires that the auditor consider *each* SFA program to be a major program.

Associated Organizations

2.36. As noted in PCIE Position Statement No. 6, Question 13—

> Not-for-profit organizations often create Associated Organizations to perform certain functions for the not-for-profit (e.g., a university athletic foundation, a university association to provide dormitory housing, a not-for-profit creating a separate not-for-profit organization to hold real estate, or a national not-for-profit organization that sponsors local chapters). Common reasons for forming these Associated Organizations are for exemption from restrictions on the NPO to raise funds or to further the purpose of the not-for-profit. In many cases, the same individuals may hold offices in both organizations or the NPO may otherwise exercise control over the Associated Organization.

2.37. PCIE Position Statement No. 6, Question 13, also states that the application of the audit requirements under Circular A-133 to such Associated Organizations will depend on the circumstances. The auditor should use the following guidelines:

- When an Associated Organization receives federal awards, either as a recipient or subrecipient, it would be subject to Circular A-133 audit requirements.
- When an Associated Organization is included in the NPO's indirect cost allocation plan, the auditor of the NPO may need to test transactions of the Associated Organization in procedures performed relative to indirect costs. The auditor should also consider whether any transactions between the NPO and Associated Organization that affect federal awards or otherwise need to be tested as part of the NPOs Circular A-133 audit. If the transactions with the Associated Organization are clearly immaterial, then additional procedures may not be necessary.

- An Associated Organization which meets *all* of the following conditions does not need to be audited under Circular A-133:
  - — It receives no direct or indirect federal awards;
  - — It is not included in the NPO's indirect cost allocation plan; *and*
  - — Otherwise it does not receive payments or benefits from the NPO which are paid out of federal funds.

Basic Requirements of Circular A-133

2.38. Circular A-133 requires an audit of the NPO's basic financial statements, additional audit tests for compliance with applicable laws and regulations, and consideration of the NPO's internal control structure over federal awards.

2.39. The audit requirements of Circular A-133 are administered on behalf of the federal government by cognizant agency representatives who are designated or agree to represent the collective interests of the federal government.

2.40. Circular A-133 requires the auditor to determine whether—

- The financial statements of an NPO present fairly its financial position and the results of its operations in conformity with generally accepted accounting principles (GAAP).[14]
- The NPO has an internal control structure to (*a*) provide reasonable assurance that it is managing federal awards in compliance with applicable laws and regulations and (*b*) ensure compliance with laws and regulations that could have a material effect on the financial statements.
- The organization has complied with laws and regulations that may have a direct and material effect on its financial statement amounts or on each major federal program.

Differences Between Circulars A-110 and A-133

2.41. Attachment F, subparagraph 2(h), of Circular A-110 includes a broad requirement for an organization-wide financial audit, to be carried out at least biennially. Since the attachment to Circular A-110 included no specific reporting requirements, its application was diverse in practice. Circular A-133 sets forth the audit requirements described in chapter 1 and above.

2.42. In 1989, the Standards Subcommittee of the PCIE, which represents the federal Inspectors General, directed in its Statement No. 5 that accountants conducting audits of federal recipients under Circular A-110 should use the audit procedures and reports set forth in a 1989 audit guide promulgated by HHS. In summary, its reporting requirements include the internal control structure and compliance reports of GAS, but do not include the separate internal control structure and compliance reports required by Circular A-133. Circular A-133 supersedes Circular A-110 audit requirements and expands the audit and reporting guidance beyond those contained in the HHS guide. As stated in PCIE Position Statement No. 6, Question 3, "Because an audit conducted in accordance with the HHS Guide would not meet the requirements of Circular A-133, PCIE No. 5 does not apply to Circular A-133 audits. However, PCIE No. 5 remains in effect for Circular A-110 audits performed prior to implementation of Circular A-133."

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[14] Bases of accounting other than GAAP are acceptable. See paragraph 7.4 of this SOP.

Differences Between Circulars A-128 and A-133

2.43. Although Circular A-133 was patterned after Circular A-128, there are differences between the two. The following paragraphs highlight the major differences.

Defining Major Programs

2.44. Major programs are defined differently in Circular A-133 than in Circular A-128. For entities that have $100 million or less in expenditures, Circular A-128 defines a major program as any program for which federal expenditures exceed the larger of $300,000 or 3 percent of such total expenditures. For entities that spend more than $100 million, Circular A-128 includes a chart that specifies the amounts used to define major programs. Paragraph 1.18 of this SOP discusses how Circular A-133 defines a major program.

2.45. Per Circulars A-128 and A-133, a program can also include several grants, but they should be grouped by their listing in the CFDA; for student financial aid and research and development programs, Circular A-133 allows broader groupings whereas Circular A-128 does not.

Disclosure of Immaterial Findings

2.46. Circular A-128 requires the auditor to include a description of all findings of noncompliance, including immaterial findings in the audit reports, but Circular A-133 does not. However, under Circular A-133, immaterial findings of noncompliance may be reported either in the report or in a separate written communication to the NPO. This separate communication is referred to in the Circular A-133 compliance reports.

Frequency of Audit

2.47. Circular A-128 requires an annual audit, unless the appropriate state or local government established a constitutional or statutory requirement for biennial audits prior to January 1, 1987.[15] Circular A-133 permits audits to be conducted every two years, but only if the recipient does not have an annual financial statement audit, in which case the PCIE has interpreted OMB Circular A-133 to require annual audits as well. If circumstances permit a biennial audit, the entire two-year period must be audited, and the determination for major programs should be based on expenditures for the two-year period. An audit performed in accordance with OMB Circular A-133 should cover the reporting entity's transactions for its fiscal year, which is not necessarily the period of the program being funded.

2.48. According to the PCIE Position Statement No. 6, Question 71, the Circular A-133 audit must be annual when the not-for-profit organization has annual financial audits. Since some not-for-profit organizations and their auditors have interpreted Circular A-133 to allow a Circular A-133 audit every two years in all cases, the Inspectors General may use judgment in accepting two-year audits in the first cycle of audits under Circular A-133.

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[15] Circular A-133 Attachment, paragraph 7, states, "Audits shall usually be performed annually but not less frequently then every two years." However, if the statute for the program requires an annual audit, then an annual audit must be performed.

For example, Section 330 of the Public Health Act, which covers community health centers, requires an annual audit. Circular A-133 guidance should be followed in performing an annual audit.

Coordinated Audit

2.49. Circular A-128 does not contain a provision for a coordinated audit approach. In recognition of the potential economies gained through mutual reliance among auditors, Circular A-133 permits a coordinated audit approach. A coordinated audit is one in which the independent auditor and federal and other auditors consider each other's work in determining the nature, timing, and extent of auditing procedures.

2.50. In most cases, the objectives of GAAS and Circular A-133 can be achieved most effectively by a single auditor, whose work and reports meet the objectives and reporting requirements described in paragraphs 12(b) and 15 of Circular A-133. In other cases, however, internal, state, local, or federal auditors or other federal representatives may be involved as well. In these cases, the auditor should consult with the other auditors to determine whether the other auditors have any work planned, in process, or completed that may be used to satisfy some or all of the other auditor's needs in performing planned work, to avoid duplication of effort. Such work includes work performed by internal auditors, other independent accountants, or specialists such as program reviewers or contracting officers. Circular A-133 states that the coordinated audit approach is not intended to limit the scope of the audit work to preclude the independent auditor from meeting the objectives and reporting requirements described in paragraphs 12(b) and 15 of that Circular. For the coordinated audit to succeed, there should be a clear understanding with the recipient, as well as among all auditors involved, as to the specific audit and reporting responsibilities of each.

2.51. If the coordinated audit approach is used, the auditor should follow, as appropriate, SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*; SAS No. 11, *Using the Work of a Specialist*; and SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*.[16]

2.52. A coordinated audit contemplates that different auditors will provide various reports required by paragraph 15 of Circular A-133. For example, a separate financial statement and compliance audit may be conducted by an auditor, other than the principal auditor, of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements of the parent NPO. Typically, the auditor of the parent will not have performed the procedures necessary to issue the required Circular A-133 reports on compliance and internal control relative to the component unit. When another auditor is involved, the other participating auditors should indicate the division of responsibility in the scope paragraph of their reports on the financial statements, compliance, and the internal control structure, rather than disclaiming an opinion on the work of the other auditor. For professional guidance, the auditor may need to refer to SAS No. 1, section 543. An auditor participating in coordinated audits should carefully evaluate the interrelationships of the work performed by others and the nature of his or her reliance on them in meeting his or her reporting responsibilities.

2.53. In overseeing "coordinated" audits, federal agencies may, in certain cases, request special reports prepared in accordance with SAS No. 62, *Special*

[16] In some cases the work of a program reviewer would qualify as that of a "specialist" under SAS No. 11. If so, the auditor would be required to satisfy himself or herself concerning the reviewer's professional qualifications and understand the purpose and nature of work performed by the specialist. In most cases, a program reviewer cannot satisfy all the work required by and planned under Circular A-133, but it can be a substitute for some of it. The auditor is still required to gain a satisfactory understanding of the internal control structure, assess control risk, and perform some testing of the specific requirements.

Reports, or reports on the internal control structure or compliance with certain laws and regulations, in addition to the reports required in accordance with paragraph 15 of Circular A-133. When participating in a coordinated audit, the auditor should understand his or her responsibilities for any additional reporting requirements, and consider documenting this understanding in an engagement letter signed by all parties, before beginning fieldwork.

Additional Audit Work

2.54. Circular A-73, *Audits of Federal Operations and Programs,* provides guidance to federal agencies responsible for processing and assessing the adequacy of audit reports prepared by nonfederal auditors who have been engaged in audits of federal programs. Circular A-73 states in part:

> Federal agencies will rely on recipient audits, provided they are made in accordance with the audit standards issued by the Comptroller General and otherwise meet the requirements of the federal agencies. Federal agencies may perform additional audit work building on the audit work already performed.

2.55. The provisions of Circular A-73 do not limit the authority of a federal agency to conduct or contract for additional audits of recipient organizations. However, under Circulars A-73 and A-133, any additional audit work should not duplicate the work already performed. Further, Circular A-133 states that federal agencies contracting for additional audit work are responsible for the additional costs involved.

Contracting for Audits

2.56. Paragraph 10 of Circular A-133 refers to the procurement standards set forth in Circular A-110. These standards provide for cost or price analysis in connection with all of a recipient's purchases, and require that this analysis be documented for procurement over a certain threshold. A responsible procurement is particularly important for audits. Among others, the Mid-America Intergovernmental Audit Forum (see appendix B) has produced sample procurement guidelines that may be useful to recipients and their auditors. Circular A-133 provides guidelines for recipients of federal awards to ensure that small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of Circular A-133.

Working Papers

2.57. Circular A-133 requires auditors to retain working papers and audit reports for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Working papers are required to be made available on request to the cognizant agency, its designee, or the GAO.

Other Literature on Organization-Wide Audits

2.58. Additional guidance on organization-wide audits has been provided by the Standards Subcommittee of the PCIE and by the AICPA. Appendix B of this SOP lists this guidance and explains how to obtain it. In the planning stage of the audit, auditors should become familiar with the applicable documents presented in appendix B, many of which are discussed in this SOP.

Chapter 3

PLANNING AND OTHER SPECIAL AUDIT CONSIDERATIONS OF OMB CIRCULAR A-133

Planning Considerations

3.1. In planning an audit in accordance with OMB Circular A-133, the auditor considers several matters in addition to those ordinarily connected with an audit of financial statements in accordance with generally accepted auditing standards and *Government Auditing Standards*. This chapter discusses overall planning considerations in an organization-wide audit in accordance with Circular A-133.

Overall Organization-Wide Audit—Planning Considerations

3.2. Matters that are relevant to planning both components of an organization-wide audit—the financial statement audit and the audit of federal financial assistance—include the following:

- Preliminary assessment of audit risk
- Materiality
- The cognizant agency
- *Government Auditing Standards*, including continuing education and quality-control requirements
- Foreign NPOs
- Subrecipients
- For-profit subrecipients
- Third-party contractors
- Additional responsibilities of the auditor
- Audit follow-up
- State award compliance
- Determination of the audit period
- Initial-year audit considerations
- Joint-audit considerations
- Quality-assessment programs
- The engagement letter
- Other audit services
- The exit conference

Preliminary Assessment of Audit Risk

3.3. SAS No. 68 requires that the auditor obtain an understanding of the possible effect of laws and regulations that are generally recognized by auditors to have a direct and material effect on the financial statements (under GAAS and GAS) and on federal financial assistance programs (under OMB Circular A-133). The auditor should consider risk factors related to these laws and regulations and to the related policies and procedures in the internal control structure.

Materiality

3.4. Materiality is a significant matter that should be considered in planning the organization-wide audit. SAS No. 47, *Audit Risk and Materiality* in Conducting an Audit, provides guidance on the auditor's consideration of materiality when planning and performing an audit of financial statements in accordance with GAAS. (See paragraphs 6.30—6.35 of this SOP for a detailed discussion of materiality.)

3.5. *Compliance Requirements.* In planning the control structure and compliance aspects of the audit, the auditor should obtain from management the principal compliance requirements from the sponsor or the organization at the start of the audit. The entity and auditor may also ascertain the principal compliance requirements for the largest federal programs by referring to the OMB's *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions.* For programs not listed, the auditor may refer to the OMB's *Compliance Supplement for Single Audits of State and Local Governments* or to the regulations and agreements governing individual programs.

3.6. Circular A-133 defines the cognizant agency as a federal agency assigned by the OMB to carry out the responsibilities with regard to an organization-wide audit as defined in paragraph 3 of the Attachment to the Circular. For some organizations subject to OMB Circular A-133, the OMB has assigned a cognizant agency. For other entities, there is an oversight agency with somewhat lesser responsibilities. Paragraph 4 of the Attachment to the Circular describes them.

Responsibilities of the Cognizant and Oversight Agencies

3.7. The OMB has designated cognizant agencies for larger not-for-profit organizations. Smaller NPOs not assigned a cognizant agency are under the general oversight of the federal agency that provides them with the most direct funding. (Where there is no direct funding, the prime recipient providing the most pass-through funding to the NPO will generally assume oversight responsibility.) For assistance in planning, conducting, and reporting on an audit conducted in accordance with Circular A-133, the recipient and auditor may wish to consider this oversight agency in the role played by the cognizant agency, described above.

3.8. Paragraph 3 of Circular A-133 states that a cognizant agency has the responsibility to—

a. Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of Circular A-133.

b. Provide technical advice and liaison to organizations and independent auditors.

c. Obtain or make quality-control reviews of selected audits made by nonfederal audit organizations and provide the results, when appropriate, to other interested organizations.

d. Promptly inform other affected federal agencies and appropriate federal, state, and local law enforcement officials of any reported illegal acts or irregularities.

e. Advise the recipient of audits that have been found not to have met the requirements set forth in Circular A-133. In such instances, the recipients are expected to work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency will notify the recipient and federal awarding agencies of the facts and make recommendations for follow-up action. Major inadequacies or repeated substandard performance of independent auditors will be referred to appropriate professional bodies for disciplinary action.

f. Coordinate, to the extent practicable, audits made for federal agencies that are in addition to the audits made pursuant to Circular A-133, so that the additional audits build upon such audits.

g. Oversee the resolution of audit findings that affect the programs of more than one agency.

h. Coordinate audit work and reporting among all auditors in order to achieve the most cost-effective audit. Seek the views of other interested agencies before completing a coordinated audit.

3.9. Additional information on the responsibility of a cognizant agency is contained in the *Federal Cognizant Agency Audit Organization Guidelines,* issued by the PCIE. It provides guidance for promoting quality audits, processing audit reports, and providing notification of irregularities

3.10. The OMB has stated that the responsibilities of an oversight agency are not as broad as those of a cognizant agency. An oversight agency's primary responsibility is to provide advice and counsel to recipients and their auditors when requested. An oversight agency may take on additional responsibilities if deemed necessary, such as ensuring that audits are conducted and transmitted to appropriate federal officials.

3.11. In addition, OMB has designated the Bureau of the Census to act as the overall clearinghouse for Circular A-133 reports.

3.12. *Communication With the Cognizant or Oversight Agency.* Although not required by Circular A-133, the auditor may, when professional judgment indicates it is appropriate, communicate with the cognizant agency. If a planning meeting is held with the cognizant agency and the recipient organization, matters such as the following may be discussed:

- The audit plan
- The scope of compliance testing of programs for specific requirements
- The intended use of the Circular A-133 Compliance Supplement
- The identification of federal awards, including those that are considered to be major programs
- The form and content of the supplemental schedule of federal awards
- Testing the monitoring of subrecipients
- The scope of consideration of internal control structure
- Testing of compliance requirements
- Status of prior-year findings and questioned costs

3.13. If the cognizant agency disagrees with significant elements of the audit plan, these matters should be resolved among the recipient, the cognizant or oversight agency (or major funder), and the auditor before fieldwork commences. Communication with and decisions rendered by the cognizant agency should be documented.

Government Auditing Standards

3.14. OMB Circular A-133 requires that the audit be performed by an independent auditor in accordance with *Government Auditing Standards.* The auditor should be aware of AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits.* Two of the general standards included in *Government Auditing Standards* relate to continuing professional education and quality control.

3.15. *Continuing Professional Education Requirements. Government Auditing Standards* requires auditors to participate in a program of continuing professional education (CPE) and training. Every two years, certain auditors performing audits in accordance with GAS should complete at least eighty credit hours of training that contribute directly to their professional proficiency. At least twenty of these hours should be completed in each year of the two-year period and at least twenty-four hours should be in topics directly related to the specific or unique environment in which the entity operates. For example, if the auditor performs audits of an entity that is a not-for-profit organization, the twenty-four hours should be in topics related to the not-for-profit accounting and auditing environment. These could include compliance and government-related courses or those broadly related to the sort of not-for-profit organization being audited.

3.16. This requirement applies to auditors responsible for planning, directing, and reporting on audits conducted in accordance with GAS and to those "conducting substantial portions[17] of field work." A detailed interpretation of the CPE standards, *Interpretation of Continuing Education and Training Requirements,* is available from the Government Printing Office (stock number 020-000-00250-6). During engagement planning, auditors and audit organizations should ensure that members of the audit team have met or will meet the appropriate CPE requirement.

3.17. *Quality Control. Government Auditing Standards* also states that the audit organization should have in place an internal quality-control system and participate in an external quality-review program (for example, peer review). An external quality review should be conducted at least once every three years.

Foreign NPOs

3.18. Auditors performing Circular A-133 audits of U.S. grantees and their subrecipients (U.S. and/or foreign based) are required to meet *Government Auditing Standards.* No specific exception is provided for foreign auditors. When a subrecipient is a foreign NPO, it may be necessary to use independent auditors who may not fully meet *Government Auditing Standards* such as the continuing education or quality control standards. In these cases, the auditor should disclose the applicable audit standards that were not met. PCIE Statement No. 6, Question 89, states that the Inspectors General, or recipients in the case of a subrecipient, are expected to use their judgment on whether to accept the reports.

3.19. A foreign NPO that is a sub-office of or otherwise included in the financial statements of a U.S.-based NPO, is generally included as part of the audit of the U.S.-based operation and not considered a subrecipient. A foreign NPO that is a subrecipient of a U.S.-based NPO would be subject to Circular A-133.[18] A foreign not-for-profit organization receiving a federal award directly from the U.S. government would be subject to the audit requirements of the terms and conditions of the award. The auditor should be aware that certain federal agencies have issued guidelines for these types of audits. For example, the AID has issued *Guidelines for Audits of AID Assistance Contracted by Foreign Recipients.*

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[17] Per the GAO *Interpretation of Continuing Education and Training Requirements,* individuals are considered responsible for "conducting substantial portions of the field work" when, in a given CPE year, their time chargeable to audits conducted under GAS amounts to 20 percent or more of their total chargeable time.

[18] General requirements may not apply to a foreign NPO. The auditor should refer to the terms of the award or discuss the matter with the granting agency.

Subrecipient Versus Vendor Responsibilities

3.20. Many NPOs and governmental units make subcontract or subaward awards and disburse their own funds as well as federal funds to subrecipients. In many instances, the amount of these payments or provisions of goods to subrecipients or vendors is material to the primary recipient's financial statements.

3.21. The difference between vendors and subrecipients is significant for purposes of the Circular A-133 audit. If an entity that receives pass-through federal funds is classified as a vendor, that vendor's responsibility is to meet the requirements of the procurement contract. If, however, the entity is classified as a subrecipient, then the primary recipient NPO must make certain that the pass-through funds are utilized in accordance with applicable laws and regulations. Examples of a typical recipient-subrecipient relationship include the following:

- A state university receives federal assistance that it disburses to other organizations throughout the state according to a formula or some other basis.
- A regional commission receives federal funds for the feeding of elderly and low-income individuals that are disbursed to not-for-profit organizations to support their feeding programs.
- A state department of social services receives federal funds that are disbursed to NPOs within the state.

3.22. The type of entity the subrecipient is determines which circular is applicable. Circular A-128 applies to state or local government subrecipients. Circular A-133 applies to institutions of higher education or other not-for-profit subrecipients.

3.23. *Subrecipient.* A subrecipient is defined in OMB Circular A-133 as "any person or government department, agency, establishment, or nonprofit organization that receives financial assistance to carry out a program through a primary recipient or other subrecipient but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a direct recipient of Federal awards under other agreements." According to PCIE Position Statement No. 6, Question 46, "a subrecipient may have some or all of the following characteristics: responsibility for applicable program compliance requirements, performance measured against meeting the objectives of the program, responsibility for program decisions, and determining eligibility for assistance."

3.24. *Vendor.* A vendor is an entity generally responsible for providing required goods or services related to the administrative support of the federal award. These goods or services may be for the recipient or subrecipient's own use or for the use of beneficiaries of the program. The vendor's only responsibility is to satisfy the terms of this contract.

3.25. Per PCIE Position Statement No. 6, Question 57, "Compliance requirements normally do not pass through to vendors. However, some transactions may be structured such that the vendor should also be responsible for compliance or the vendor's records must be reviewed to determine compliance. In these cases, the NPO is responsible to ensure compliance for applicable transactions by vendors. Methods to ensure this compliance are pre-award audits, monitoring during the contract, and post-award audits. Audits may be done or procured by the NPO or the terms and conditions of the contract may require the vendor to procure the audit."

3.26. PCIE Position Statement No. 6, Question 58, states that "when the auditor cannot obtain compliance assurances from reviewing the not-for-profit's records and monitoring procedures, the auditor will need to perform additional procedures to determine compliance. These procedures may include testing the vendor's records or relying on work performed by the vendor's independent auditor." PCIE Position Statement No. 6, Question 46, notes that the distinguishing characteristics of a vendor include:

- Providing the goods or services within normal business operations
- Providing similar goods or services to many different purchasers
- Operating in a competitive environment
- Program compliance requirements that do not pertain to the goods or services provided

3.27. The following considerations may help the organization and its auditor decide whether the entity is a subrecipient or a vendor. In some cases, it may be difficult to determine whether the relationship with the NPO is that of a subrecipient or of a vendor. In those cases, the organization and the auditor should make a decision based on the preponderance of answers.

	Yes	*No*
1. Are the funds being disbursed directly or indirectly from a federal source?	Indicative of subrecipient	Cannot be subrecipient
2. Is the receiving entity a not-for-profit or a governmental entity?	No distinction made	Indicative of vendor
3. Does the entity that receives the funds have the authority for administrative and programmatic decision-making responsibility and/or eligibility determination?	Indicative of subrecipient	Indicative of vendor
4. Are the services provided by the entity ongoing as opposed to occasional?	Indicative of subrecipient	Indicative of vendor
5. Do contracts with the entity state that they are to comply with all applicable laws and regulations? Are there performance requirements that must be met and reported?	Indicative of subrecipient	Indicative of vendor

3.28. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. The federal cognizant, oversight, or sponsoring agency may be of help in making these determinations.

3.29. Federal awards normally are redistributed to subrecipients only on the basis of properly completed and approved awards. These written agreements require subrecipients to comply with the requirements of the federal agency and additional requirements established by the pass-through organization. Hence, the auditor may be required to test compliance, for example, with state as well as federal reporting requirements.

Subrecipient Audits

3.30. Under the requirements of Circular A-133, if in a single fiscal year a recipient of a federal award passes through $25,000 or more of that federal award to a subrecipient, the primary recipient is responsible for determining that the subrecipient expends that award in accordance with applicable laws and regulations.[19] Further, Circular A-133 provides that in such instances, the primary recipient should—

- Determine whether not-for-profit subrecipients and, if applicable, governmental subrecipients covered by Circular A-128, have met the audit requirements of Circulars A-133 and A-128, respectively.[20]
- Determine whether the subrecipient spent federal funds provided in accordance with applicable laws and regulations.
- Ensure that appropriate corrective action on reported instances of noncompliance with federal laws and regulations is taken within six months after receipt of the subrecipient audit report.
- Consider whether subrecipient audits necessitate adjustment of the recipient's own records.
- Require each subrecipient to permit independent auditors to have access to their records and financial statements as necessary to comply with Circular A-133.

3.31. Prime recipients are responsible for identifying federal awards to subrecipients. However, when the not-for-profit subrecipient is unable to identify the amount of the award which is federal, the full amount should be considered a federal award of the NPO. The full amount should also be reported on the schedule of federal awards with a footnote that the federal amount cannot be determined.

3.32. Although the threshold per Circular A-133 for monitoring subrecipients is $25,000 provided to a subrecipient, Circular A-110 includes certain responsibilities for recipients to monitor subrecipients, regardless of the amount of the subaward.

3.33. Those responsibilities may be discharged by relying on the subrecipients' Circular A-133 audits, relying on appropriate procedures performed by the primary recipient's internal audit or program management personnel, expanding the scope of the independent financial and compliance audit of the primary recipient to encompass testing of subrecipients' charges, or a combination of these procedures.

3.34. The primary recipient is also responsible for reviewing audit and other reports submitted by subrecipients, identifying questioned costs and other findings pertaining to the federal awards passed through to the subrecipients, properly accounting for and pursuing resolution of questioned costs,

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[19] Per PCIE Position Statement No. 6, Question 54:

If the prime recipient does not inform the subrecipient that a Federal award is being passed through, and the subrecipient otherwise is not aware that the award is Federal or that an audit is required, then the prime recipient is responsible to make arrangements with the subrecipient for the proper audit. The prime recipient is ultimately responsible for Federal awards passed through to a subrecipient.

The determining factor for A-133 audit requirements is the dollar amount of Federal awards received, not whether the audit is requested. All not-for-profit subrecipients whose total Federal awards received meet the dollar thresholds are required to have an A-133 audit. However it is essential that the prime recipient identify Federal awards to the subrecipient.

If the prime recipient fails to advise the subrecipient that the award is Federal, this should be considered a weakness in the prime recipient's internal control system for monitoring subrecipients.

[20] In some cases, the award passing through the prime recipient to the subgrantee is the only such award the subrecipient receives. If the subrecipient qualifies for a program-specific audit under such circumstances (see paragraph 2.28), then it would be appropriate for either the prime recipient or the subrecipient to engage an auditor to perform the program-specific audit. When an organization-wide audit is required under Circular A-133, separate program-specific audits of this type will not meet the requirements of the Circular.

and ensuring that prompt and appropriate corrective action is taken in instances of material noncompliance with laws and regulations.

3.35. In establishing its control policies and procedures to monitor subrecipients, the primary recipient should design procedures sufficient to determine a subrecipient's noncompliance with applicable federal rules and regulations that could be material to the subaward. Financial operations of subrecipients related to the federal awards may be subjected to timely and periodic audits. If not, the primary recipient should develop alternative procedures for monitoring their subrecipients, The primary recipient may perform monitoring procedures such as the following:

- Review grant applications submitted by subrecipients to determine that—
  - — Applications are approved by subgrantor management before any funds are awarded.
  - — Applications are filed in a timely manner.
  - — Each application contains the condition that the subrecipient comply with the federal requirements set by the initial federal grantor agency.
- Establish control policies and procedures to provide reasonable assurance that funds are disbursed to subrecipients only on an as-needed basis.
- Disburse funds to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis.
- Bill and collect refunds due from subrecipients in a timely manner.
- Establish control policies and procedures to provide reasonable assurance that subrecipients and those using the funds meet eligibility requirements.
- Review financial and technical reports received from subrecipients on a timely basis and investigate all unusual items.
- Review submitted audit reports to evaluate for completeness and for compliance with applicable laws and regulations to determine whether the appropriate reporting standards were followed.
- Evaluate audit findings, issue appropriate management decisions, if necessary, and determine if an acceptable plan for corrective action has been prepared and implemented. If considered necessary, review the working papers of the auditors.
- Review evidence of previously detected deficiencies and determine that corrective action was taken.

3.36. The auditor of the primary recipient should develop an understanding of the design of the recipient's policies and procedures used to monitor subrecipients and determine whether they have been placed in operation. The auditor should also assess the level of control risk by evaluating the effectiveness of the primary recipient's control policies and procedures in preventing or detecting subrecipients' noncompliance with the applicable laws and regulations.

3.37. When awards to subrecipients are part of a major program (or a nonmajor program used to meet the 50-percent rule described in paragraph 1.32 of this SOP), the auditor should test the NPO's control policies and procedures used to monitor subrecipients. The tests of controls may include inquiry, observation and inspection of documentation, or a reperformance by the auditor of some or all of the monitoring procedures identified above as the primary recipient's responsibilities. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the control structure policies and procedures, and professional judgment.

3.38. The instances of noncompliance reported in a subrecipient's audit report are not required to be included in the primary recipient's audit report. However, as noted above, the recipient has a responsibility to resolve subrecipients' audit findings directly related to the primary recipient's programs. Thus, the auditor should consider the effects on a major program (or a nonmajor program used to meet the 50-percent rule described in paragraph 1.32 of this SOP) of instances of noncompliance reported in subrecipient audit reports, or reportable conditions, including material weaknesses, in the primary recipient's control policies and procedures used for monitoring the subrecipient.

3.39. In many cases, the primary recipient will not have received all subrecipient audit reports in time to incorporate the results into its own audit. Circular A-133 does not require that the reports for prime and subrecipient be issued simultaneously, but that the primary recipient have control policies and procedures to determine that subrecipient audit reports have been received and that corrective action is taken within six months after receipt of the subrecipient's audit report. A subrecipient's audit report may cover a previous period; in choosing whether to use such a report to meet the requirements described previously, the auditor should consider the period covered by the report and its date of issuance. As long as the audit report of the subrecipient is current, it need not cover the same period as the prime recipient's audit. If the subawards are not material to the financial statements and the major programs of the primary recipient, the primary recipient and its auditor should be able to rely on the grantee's subrecipient audit cycle, even if it is not coterminous with the primary recipient's fiscal year.

3.40. If subrecipient audits have not been made and the grant awards are material to the financial statements or programs administered by the primary recipient, the scope of the primary recipient's audit can be expanded by management to include testing of the subrecipient records for compliance with the applicable provisions of the general and specific requirements. If the scope of the audit is not expanded, the auditor should consider disclosing the amount of the subaward as a questioned cost and modifying the auditor's report on compliance with laws and regulations. Additionally, the auditor should consider whether deficiencies in the primary recipient's control policies and procedures used to monitor subrecipients may exist.

3.41. Per PCIE Position Statement No. 6, Question 53, a prime recipient government's internal auditor who is independent and otherwise meets the qualifications and standards prescribed by Circular A-133 and *Government Auditing Standards* may perform the audit required by Circular A-133 for a subrecipient. However, nongovernmental internal auditors could not perform and report upon subrecipients' audits under Circular A-133 because they are not included in the Circular A-133 definition of independent auditor. A prime recipient's internal auditor, either governmental or nongovernmental, may be used, however, to monitor the subrecipient or assist the independent auditor.

For-Profit Subrecipients

3.42. Circular A-133 does not require audits of for-profit entities. However, an NPO is responsible for ensuring that expenditures from all federal awards are made in accordance with applicable laws and regulations. Methods to ensure compliance for funds passed through to for-profit subrecipients are pre-award audits, monitoring during the contract, and post-award audits.

3.43. A prime recipient has the same responsibilities for funds passed through to for-profit subrecipients as it has for not-for-profit subrecipients *except* that Circular A-133 does not establish for-profit subrecipient audit requirements. Since audit requirements are not specified, the contract with the for-profit subrecipient should include applicable administrative, general, and specific compliance requirements.

3.44. PCIE Position Statement No. 6, Question 49, states that NPOs should consider establishing appropriate audit requirements and including them in contracts with for-profit subrecipients. Audit requirements a prime recipient may consider including in contracts with a for-profit subrecipient are—

- An audit in accordance with the requirements of Circular A-128 or Circular A-133.
- A program-specific audit.
- Audits and monitoring similar to circumstances involving vendors, as described in paragraphs 3.25 and 3.26 of this SOP.

3.45. When a for-profit subrecipient has not had an audit, the prime recipient's auditor is responsible for determining compliance with applicable program requirements. The auditor may meet this responsibility either by reviewing relevant records at the NPO and considering the NPO's control policies and procedures used to monitor the subrecipients, or by performing tests of compliance of the for-profit's records.

Additional Responsibilities of the Auditor

3.46. The auditor may also be engaged to test and report on compliance with state and local laws and regulations in addition to those set forth in *Government Auditing Standards* and OMB Circular A-133.

Audit Follow-Up

3.47. The section entitled "Audit Follow-Up" in chapter 3 of *Government Auditing Standards* states:

> Due professional care also includes follow-up on known findings and recommendations from previous audits that could have an effect on the current audit objectives to determine whether prompt and appropriate corrective actions have been taken by entity officials or other appropriate organizations. . . . The auditor's report should disclose the status of known but uncorrected significant or material findings and recommendations. . . .

3.48. The auditor should review the status of action taken on findings reported in prior audits or program reviews, whether they were conducted by independent auditors or by the grantor agency's personnel. When corrective action has not been taken, the deficiency remains unresolved and could be significant or material in the current audit period, the auditor should briefly describe the prior finding and refer to the page on which it appears in the current report. If there were no prior findings and recommendations, a note stating that may be included in the audit report.

State and Local Award Requirements

3.49. In addition to the requirements imposed on recipients by OMB Circular A-133, there may be state award requirements imposed by states that make grants to their political subdivisions and NPOs. In connection with the financial statement audit, the auditor should obtain an understanding of applicable state reporting and compliance requirements that have a direct and material effect on the financial statements being audited. If engaged to audit state grant activity, the auditor should consider performing the following procedures:

- Inquire of management about additional compliance auditing requirements applicable to the entity.
- Inquire of the office of the state or local auditor or other appropriate audit oversight organizations about audit requirements applicable to the entity.
- Review information about governmental audit requirements available from state societies of CPAs or associations of governments.

3.50. When the engagement includes auditing compliance with a state or local award, the auditor should consider performing the following steps:

- Read the grant agreements and any amendments.
- Obtain any applicable audit guidance from the state grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.
- When appropriate, discuss the scope of testing that is expected to be performed with the state grantor agency.

3.51. Nonfederal awards received by an NPO from a state or other organization should be distinguished from the federal pass-through funds received. These nonfederal pass-through funds are not considered part of the total federal awards received by an NPO and are not subject to audit in accordance with OMB Circular A-133. The recipient of federal awards that provides pass-through funds to a subrecipient has the responsibility of notifying the subrecipient of *(a)* the amount of federal awards included in the pass-through and *(b)* the federal program name and CFDA number from which such awards were derived.

3.52. To become familiar with any additional requirements of state and local grantors, the auditor of a not-for-profit organization should consider performing planning procedures such as the following:

- Inquire about sources of revenue received by the organization and about restrictions, limitations, terms, and conditions under which such revenue is received. Review any agreements directly related to revenue (for example, loans and grants) and inquire about the applicability of any overall regulations of governmental sponsors that apply to the revenue or accounting for the revenue.
- Inquire about compliance and reporting requirements. The audit divisions of sponsoring agencies usually can be helpful in identifying these requirements, which may be identified separately for each recipient or published in an audit guide.

Determination of the Audit Period

3.53. An audit performed in accordance with OMB Circular A-133 should cover the reporting entity's financial transactions for its fiscal year (or a two-year period, if there is no annual audit of the financial statements), which is not necessarily the same as the period of the program being funded. Thus, the audit might include only a part of the transactions of a federal award program because some transactions may not occur within the period covered by the audit.

Initial-Year Audit Considerations

3.54. An auditor accepting, or contemplating accepting, an engagement in which the federal awards of the preceding period were audited by another auditor is guided by SAS No. 7, *Communications Between Predecessor and Successor Auditors*. If the awards have not been previously audited, the auditor should discuss with the recipient and the cognizant agency the need to perform any additional audit work for the prior unaudited periods. If additional work is not required, testing for the prior unaudited period would be limited to balances as of the end of that unaudited period.

Joint Audits and Reliance on Other Auditors

3.55. In order to comply with Circular A-133's provisions with regard to small and minority firms, certain NPOs may engage small, minority, or socially or economically disadvantaged independent accounting firms on a joint-venture or subcontract basis. In these instances it will be necessary to refer to the work of other auditors.

3.56. Prior to entering into an agreement to perform an audit or to subcontract with another firm, the auditor should consider SAS No. 1, section 543, and, for audits of applicable foreign subrecipients, the AID audit guidelines.

3.57. At a minimum, the auditor should—

- Ensure his or her own independence of the oversight entity and of each component unit in reporting entity.
- Confirm the other auditor's independence under Ethics Interpretation 101-10.
- Obtain separate audited financial statements and schedule of federal awards of each component unit.
- Ascertain that an appropriate subsequent-event review was performed for the reporting entity, including all component units and federal programs. This review should include a review of correspondence the entity received after the audit date.
- Obtain representation that the other audit organization and its personnel have met the requirements of *Government Auditing Standards*, including CPE, internal quality control, and external triennial quality control review.

3.58. In some circumstances, each of the auditors participating in the organization-wide audit will have jointly signed an audit report. Signing a report is appropriate only if the auditor is in a position that would justify his or her being the only signatory of the report.

3.59. If part of the organization-wide audit is performed by governmental auditors,[21] the auditors should be satisfied that the government auditors meet the independence standards in chapter 3 of *Government Auditing Standards* as well as the CPE and quality control. These standards require that government auditors be free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance.

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[21] See paragraphs 2.49 through 2.53 of this SOP, which describe the coordinated audit.

Quality Control Reviews

3.60. In addition to the quality control requirements set forth in *Government Auditing Standards*, cognizant agencies have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews. As a part of the cognizant agencies' evaluation of completed reports of such engagements and, as required by Circular A-133, the supporting audit working papers must be made available upon request of the representative of the inspector general. Audit working papers are typically reviewed at a location agreed upon by the cognizant agency and the independent auditor. SAS No. 41, *Working Papers,* discusses certain matters related to the ownership and custody of working papers. SAS No. 41 states that "[working papers are the property of the auditor, and some states have statutes that designate the auditor as the owner of the working papers.]" Circular A-133 states that workpapers and reports shall be retained for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Audit workpapers shall be made available upon request to the cognizant agency, its designee, or the General Accounting Office at the completion of the audit.

3.61. Whenever a review of the audit report or the working papers discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are identified and the representative of the local cognizant agency determines that the audit report and the working papers are substandard, cognizant agencies may take further steps. In those instances where the audit was performed by a certified public accountant and the work was determined to be substandard by the Office of Inspectors General, the matter may be submitted to state boards of public accountancy.

Engagement Letters

3.62. It is in the best interest of both the auditor and the organization to document the planning and scope of the audit in an engagement letter. This may minimize confusion and help ensure a proper understanding of the responsibilities of each party. Although not required, the auditor may wish to discuss the engagement letter with the cognizant agency. Appendix G of this SOP presents an example engagement letter. Auditors should consider describing items such as the following:

- The requirements of *Government Auditing Standards*
- The additional reports required by OMB Circular A-133
- The auditor's and organization's responsibility with respect to reporting illegal acts noted during the audit (see pages 5-4 to 5-6 of *Government Auditing Standards*)
- The period covered
- The financial statements and/or programs to be audited
- The reports to be prepared

Auditors should also consider ensuring—

- That representatives of the cognizant agency will have access to the workpapers.
- That these workpapers will be retained for at least three years after the date of the report, or longer if so requested by the cognizant agency.

Other Audit Services

3.63. Footnote 6 of this SOP notes that if auditors are engaged to perform an audit in accordance with GAAS and discover during the course of the audit that the entity should be obtaining an audit in accordance with *Government Auditing Standards* or Circular A-133, the auditor has an obligation to notify the entity of the requirement for a higher-level engagement (see paragraphs 4 and 5 of SAS No. 68). Circumstances that may indicate higher-level audit requirements include—

- A review of laws, contracts, policies, or grant agreements that contain audit requirements.
- The discovery that the NPO received over $25,000 in federal awards in the year under audit.

Exit Conference

3.64. Upon completion of the fieldwork, the auditor may hold a closing or exit conference with senior officials of the organization. In the case of decentralized operations, as at a university, the federal government encourages preliminary meetings with deans, department heads, and other operating personnel who have direct responsibility for financial management systems and administration of sponsored projects.

3.65. The exit conference gives the auditor an opportunity to obtain management's comments on the accuracy and completeness of his or her facts and conclusions. This conference also serves to provide the organization with advance information so that it may initiate corrective action without waiting for a final audit report. Whenever possible, the concurrence or the reasons for nonconcurrence by the organization should be obtained and incorporated in the auditor's report. Information on any corrective measures taken or promised to be taken by the organization should also be included in appropriate sections of the report under a caption such as "Organization's Comments."

3.66. The auditor may consider documenting the auditors who conducted the exit conference, the names and positions of the organizational representatives with whom exit conferences were held, details of the discussions, and the comments of the organizational officials.

Chapter 4

SCHEDULE OF FEDERAL AWARDS

Types of Awards and Payment Methods

4.1. There are over 1,000 individual grant programs and several distinct types of federal awards payment methods. Many of these programs are described in the CFDA.

4.2. Programs in the CFDA are classified into fifteen types of assistance. Benefits and services are provided through seven financial and eight nonfinancial types of assistance. The following list describes the eight principal types of assistance that are available.

- *Formula grants.* Allocations of money to NPOs in accordance with a distribution formula prescribed by law or administrative regulation, for activities of a continuing nature not confined to a specific project. One example is the Department of Agriculture's award to land-grant universities for cooperative extension services.
- *Project grants.* The funding, for fixed or known periods, of specific projects, or the delivery of specific services or products without liability for damages resulting from a failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, construction grants, and unsolicited contractual agreements.
- *Direct payments for specific use.* Financial assistance provided by the federal government directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon the recipient's performance. These do not include solicited contracts for the procurement of goods and services for the federal government.
- *Direct payments with unrestricted use.* Financial assistance provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed on how the money is spent. Included are payments under retirement, pension, and compensation programs.
- *Direct loans.* Financial assistance provided through the lending of federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- *Guaranteed insured loans.* Programs in which the federal government makes an arrangement to indemnify a lender against part of any defaults by those responsible for repayment of loans.
- *Insurance.* Financial assistance provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through a private carrier, and may or may not involve the payment of premiums.
- *Sale, exchange, or donation of property and goods.* Programs that provide for the sale, exchange, or donation of federal real property, personal property, commodities, and other goods including land,

buildings, equipment, food, and drugs. This does not include the loan of, use of, or access to federal facilities or property.

Payment Methods

4.3. Awards may be paid to NPOs directly or indirectly through reimbursement arrangements in which recipient organizations bill grantors for costs as incurred. Some programs provide for advance payments. Other programs permit organizations to draw against letters of credit as grant expenditures are incurred. Certain grants have matching requirements in which participating NPOs must contribute a proportionate share of the total program costs.

Noncash Awards

4.4. Most federal awards are in the form of cash awards. However, some federal programs do not involve cash transactions with NPOs. These programs usually involve commodities received, loan guarantees, loans, or insurance. The value of both cash and noncash awards should be reported as part of the schedule of federal awards or included in a footnote to the schedule. For example, the value of commodities distributed is generally included on the schedule of federal awards either as an expenditure or in a note. The existence and value of federal guarantee, loan, or insurance programs at the end of the fiscal year should be disclosed in a footnote to the schedule. Also, the value of commodities in inventory should be shown in the organization's financial statement or in a footnote to the financial statements. Any interest, subsidy, or administrative cost allowance received during the fiscal year under a loan or loan guarantee program should be included on the schedule.

4.5. The individual sources of financial assistance may not be separately identifiable, because of commingled assistance from different levels of government. If commingled assistance is identified, auditors should consider the requirements prescribed by each individual source. For example, a department of state government may receive financial assistance from the federal government and then pass the federal funding through to an NPO, supplemented with its own funds. If this occurs, the subrecipient NPO may be responsible for complying with both federal and state requirements governing that assistance. (See paragraphs 3.30 through 3.41 of this SOP for discussion of subrecipient considerations.) If management or the auditor believes that federal awards may represent combined assistance from various levels of government, management should review contracts or other documents to determine the source of the assistance. If the documentation indicates that awards received from various sources may have been commingled, the subrecipient should make inquiries of the granting agency to determine (*a*) whether the assistance provided includes assistance from other sources, (*b*) the sources and amounts of that additional assistance, if any, and (*c*) the program through which that assistance was provided. PCIE Position Statement No. 6, Question 55, states that, if the commingled portion cannot be separated to specifically identify the individual funding sources, the total amount should be included in the schedule with a footnote describing the commingled nature of the funds. The PCIE suggests that the auditor consider the total amount as federal funds in order to determine the nature and extent of tests.

Identification of Major Programs

4.6. Once all sources of federal awards have been identified, federally sponsored programs should be ranked as major and nonmajor according to the amount of expenditures. Noncash assistance should be valued to complete the ranking process, which is described further in paragraphs 2.12 through 2.15 of this SOP.

General Presentation Guidance

4.7. Paragraph 15(c)(1) of the Attachment to Circular A-133 requires that the auditor report on a schedule of federal awards.

4.8. The information that should be presented on the schedule includes—

- An identification of each major program (except student financial-aid and research-and-development programs) as it is identified in the CFDA (normally by program or grant title, and by federal agency and CFDA number).
- An identification of totals for student financial aid and research and development.
- Other federal awards (those federal programs that have not been assigned a catalog number).
- Total expenditures for each federal award program by grantor, department, or agency.
- Total federal awards.

4.9. PCIE Position Statement No. 6, Question 29, discusses schedule presentation and includes the following guidance:

- The entity and period covered by the Schedule should be the same as those covered by the financial statements.
- The same program (i.e., same CFDA number) from different program years may be combined on one line, though where feasible, presenting program years separately may make the schedule more useful to federal sponsors.
- Major programs should be specifically identified as such.
- Funds passed through from other recipients should be identified as pass-through funds and include the name of the awarding organization, the program identifying number, and the CFDA number.
- The existence and value of federal loans, loan guarantees, or insurance programs at the end of the fiscal year should be disclosed in a note to the schedule.
- Noncash assistance should be shown either in the schedule or in footnotes and valued at fair market value at the time of receipt. Women/Infants/Children program vouchers may be valued either at maximum allowed redemption value or average redeemed value.
- Interest subsidies or administrative cost allowances received under a loan or loan guarantee program should be included in the schedule.
- While not required, it is recommended that where feasible, the NPO provide additional requested information that will make the schedule easier for federal agencies to use. Examples are identification of matching funds, funds passed through to a subrecipient, individual grant numbers or amounts, and grant revenue.

4.10. Circular A-133 describes three categories of awards: (*a*) research and development (R&D), (*b*) student financial aid (SFA), and (*c*) individual awards not in an R&D or SFA category (Individual Awards—Other). Paragraphs 4.12 through 4.15 of this SOP summarize guidance provided by Question 29 of PCIE Position Statement No. 6.

4.11. Although Circular A-133 permits the total of R&D or SFA categories to be listed as one line item on the schedule, more specific identification, such as the following, is generally expected by federal agencies.

R&D

4.12. Where practicable, each individual R&D award should be listed as a separate line in the schedule. However, in some cases, such as a large NPO with many R&D awards, it may not be practical to list each award. In this case, total expenditures may be listed by each federal agency and major subdivision within each federal agency. For example, in the Department of Health and Human Services, a major subdivision would be the National Institutes of Health.

SFA

4.13. Where practicable, each individual SFA program should be listed as a separate line in the schedule by CFDA number. In any case, programs supported by different federal agencies should be listed separately. The existence and value of SFA loans made during the audit period should be shown as a footnote. For institutions of higher education that are not lenders, the footnote amount would be new loans made during the fiscal year. For other not-for-profit organizations, the footnote amount would be the total of new loans made during the fiscal year plus the balance of loans for previous years for which the government is still at risk.

Individual Award—Other (Major)

4.14. Each Individual Award—Other, that is a major program should be listed as a separate line in the schedule by CFDA number.

Individual Awards—Other (Nonmajor)

4.15. Each individual nonmajor award should be listed as a separate line in the schedule by CFDA number under the caption "Other Federal Assistance." Where individual listing is not practicable, the awards should be grouped by awarding agency.

4.16. PCIE Position Statement No. 6, Question 36, notes that expenditures may exceed the amount of the award when additional nonfederal sources provide support for a program. The Schedule may present nonfederal expenditures but should separately identify federally funded expenditures.

4.17. Paragraph 13(c)(2) of Circular A-133 requires NPOs to "identify, in their accounts, all federal funds received and expended and the programs under which they were received." Therefore, when federally funded expenditures cannot be separately identified, the auditor should include a finding in the report on compliance recommending that the NPO separately identify federal funds in subsequent periods.

4.18. PCIE Position Statement No. 6, Question 36, states that, "when expenditures in excess of current awards represent additional amounts the NPO intends to bill a Federal program, the amount and circumstances concerning the excess should be disclosed in a footnote."

4.19. Depending on the circumstances of the engagement and the requirements of federal program managers, the schedule may also include other information for each program, such as the following:

- Matching contributions
- Amount of the program award
- Receipts or revenue recognized

- Beginning and ending balances, such as unexpended amounts or accrued (deferred) amounts

4.20. The financial information included in the schedule should be derived from the organization's books and records from which the basic financial statements were prepared. It should be prepared to the greatest extent practical on a basis consistent with other federal grant reports. However, the information included in the schedule may not fully agree with the grant reports because, among other reasons, the grant reports—

- May be prepared on a different fiscal period.
- May include cumulative (from prior years) rather than only current-year data.

4.21. Because the information should be presented in the schedule on a basis consistent with other federal grant reports, it may not agree with the basis of accounting used to prepare the NPO's financial statements. Although a reconciliation should be possible, it is not expected that the schedule's data will be directly traceable to the NPO's financial statements, because grant activity is usually not separately identifiable in the fund presentation used in the basic financial statements. The basis of accounting should be discussed in a footnote.

4.22. Subrecipients of federal awards should identify program funds that are received directly from the federal government and those that are received as pass-throughs from another NPO or governmental unit. For those funds received from another NPO, the program's identifying number(s) from the CFDA should be included.

4.23. PCIE Position Statement No. 6, Question 40, states that "the CFDA number should be available for most domestic Federal financial assistance. Federal agencies and prime recipients are required to provide the CFDA number to recipients and subrecipients when awarding assistance. Not-for-profit organizations are required to identify in their accounts the programs under which funds are received."

4.24. International programs and cost-type contracts will normally not have a CFDA number. When the CFDA number is not available, the not-for-profit organization should include in the schedule the program name or other identifier obtained from the award documents.

4.25. Because federal agencies are the primary users of the supplementary schedule, financial data for state and other nonfederal assistance are not usually presented in it. If such nonfederal data is presented, it should be segregated and clearly designated as nonfederal.

4.26. In assessing the completeness of the schedule of federal awards programs, the auditor should consider, among other things, evidence obtained from procedures performed in the audit of financial statements, such as evaluating the completeness and classification of recorded revenues and expenditures. This may include sending confirmations to granting federal agencies or prime recipients when conducting an audit of a subrecipient.

4.27. Appendix E of this SOP provides an illustration of a schedule of federal awards that incorporates the described levels of disclosures.

4.28. Other supplemental information may be provided by the NPO if it is considered necessary to meet requirements for full disclosure of grants or other agreements from federal funding sources. The supplemental information may consist of the reconciliation of financial status reports (FSRs) with the schedule of federal award, or other information that the auditor believes is necessary for full disclosure of federal programs.

Chapter 5

CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE

5.1. As noted in chapter 1, in an organization-wide audit, the auditor must consider the requirements of generally accepted auditing standards and *Government Auditing Standards,* as well as those of OMB Circular A-133. In most cases, these will be met as part of the single organization-wide effort.

Consideration of the Internal Control Structure in an Audit Conducted in Accordance With GAAS

5.2. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* requires the auditor to obtain an understanding of the internal control structure that is sufficient to plan the audit and to assess control risk for the assertions embodied in the financial statements. In all audits of financial statements, including those of an NPO, this understanding incorporates knowledge about the design of internal control structure policies and procedures relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, and about whether those policies and procedures are in operation.

5.3. In planning the audit, such knowledge should be used to—

a. Identify types of potential misstatements.

b. Consider factors that affect the risk of material misstatements.

c. Design substantive tests.

5.4. Policies and procedures for all three elements of the internal control structure (control environment, accounting system, and control procedures) may influence the auditor's assessment of control risk for assertions affected by compliance with laws and regulations. For example, the elements of a control environment that may influence the auditor's assessment of control risk include—

- Significant pass-through of funds to subrecipients.
- Requirement to include only allowable and allocable costs in amounts claimed for reimbursement.
- Management's awareness, or lack of awareness, of relevant laws and regulations.
- Organization policy regarding such matters as acceptable operating practices and codes of conduct.
- Assignment of responsibility and delegation of authority for dealing with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- A mixture of volunteers and employees participating in operations. Depending on the size and other features of an organization, day-to-day operations sometimes are conducted by volunteers instead of employees. The manner in which responsibility and authority are delegated varies among organizations, which may affect the control over financial transactions, particularly with respect to authorization.

- A limited number of staff personnel, which sometimes may be too small to provide for appropriate segregation of duties.
- A volunteer governing board, many of whose members serve for limited terms.
- A budget approved by the governing board. The budget may serve as authorization for management to carry out activities in order to achieve an organization's program objectives. Many NPOs prepare budgets for both operating and capital expenditures.

Procedures to Obtain the Required Understanding

5.5. Procedures to obtain an understanding of the organization's internal control structure include the following:

- Obtain background data on the nature of the organization's control environment, including its key staff members. Documents such as the organization's charter, bylaws, and organizational chart may prove helpful.
- Obtain an understanding of the system and control procedures through inquiry, narratives, flowcharts, and other means.
- Obtain a schedule of federal awards and understand what major and nonmajor programs exist and the related general and specific requirements.
- Obtain a copy of the most recent audited financial statements of the organization and review them to determine the nature and volume of sponsored activity (that is, activity for which the organization receives financial assistance) and for indications of problems that relate to sponsored programs.
- Obtain copies of the most recent audit reports on sponsored programs issued by the cognizant agency, other federal or state agencies, or independent auditors. Follow up on the most recent audit findings to determine whether the organization has taken corrective action. This follow-up should include any additional findings or recommendations presented by the cognizant agency in its letter transmitting the report to financial officers.
- Tour the organization and meet its key employees.
- Obtain management identification of applicable laws and regulations and assess it for completeness.
- Obtain an understanding of the internal control structure related to the federal awards.

5.6. The auditor should consider whether deficiencies in such internal control structure policies and procedures should be reported in accordance with SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit.*

Consideration of the Internal Control Structure in an Audit Conducted in Accordance With *Government Auditing Standards*

5.7. Except for certain reporting requirements, *Government Auditing Standards* does not require the auditor to perform any additional work on the internal control structure beyond that required in an audit conducted in accordance with GAAS. Chapter 5 of *Government Auditing Standards* includes requirements beyond those set forth in SAS No. 60 concerning the communication of internal control structure deficiencies, which are described in paragraph 7.6 of this SOP. *Government Auditing Standards* requires auditors to prepare a written report on their understanding of an entity's internal control structure, and whether the controls have been placed in operation, and on their assessment of control risk. A description of the report, which is based on the results of procedures performed as part of an audit of the financial statements in accordance with GAAS, is described in paragraph 7.5 of this SOP and paragraphs 40 through 42 of SAS No. 68. The report is illustrated in exhibit D-3 of appendix D to this SOP.

Consideration of the Internal Control Structure in an Audit Conducted in Accordance With Circular A-133

5.8. Circular A-133 establishes additional audit procedures and reporting relative to the auditor's consideration of the internal control structure beyond those of a financial-statement audit conducted in accordance with GAAS and *Government Auditing Standards*. These requirements are discussed in the following paragraphs.

The Internal Control Structure Used in Administering Federal Awards

5.9. Circular A-133 requires the auditor to obtain an understanding of, assess control risk for, and perform tests of controls on the policies and procedures designed to provide reasonable assurance that an organization is managing federal awards in compliance with applicable laws, regulations, and contract terms and that it safeguards federal funds. The auditor's internal control structure responsibility under Circular A-133 also includes testing a recipient's system for monitoring subrecipients and the controls in effect to ensure that direct and indirect costs are properly computed and billed. These internal controls will be referred to throughout the remainder of this SOP as the *internal control structure over federal awards,* to distinguish them from the larger internal control structure of which they are a part.

5.10. Circular A-133 defines the internal control structure used in administering federal awards as the policies and procedures established to provide reasonable assurance that—

a. Use of resources is consistent with laws, regulations, and award terms.

b. Resources are safeguarded against waste, loss, and misuse.

c. Reliable data are obtained, maintained, and fairly disclosed in reports.

5.11. In addition to these basic control policies and procedures, Circular A-110 and other federal pronouncements (such as program handbooks and guides) specify uniform administrative requirements for grants and agreements with NPOs. Among the administrative requirements are those regarding cash depositories, bonding and insurance, record-retention procedures, program income, cost sharing, matching, financial reporting, monitoring and reporting of program performance, payment requirements, revisions of financial plans, closeout procedures, suspensions and terminations, applications for federal assistance, and standards for property management and procurement.

5.12. Although some of these control policies and procedures may have been considered by the auditor in the audit of the financial statements, particularly where federal awards are significant to the financial statements, others go beyond those an auditor may have considered in the audit of the financial statements, as they relate to distribution of salaries, invoice clearance, account reporting, cost transfers, and other matters. In certain cases, deficiencies in administrative procedures (such as those regarding cash receipts, cost sharing, procurement, property management, and financial reporting) may not be significant to the financial statement audit, but may be significant to the operation of federally sponsored programs. Consequently, the OMB has considered these administrative requirements to be a general requirement in the Compliance Supplements.

5.13. Although Circular A-133 requires a *report* on the internal control structure, it does not require the auditor to express an *opinion* on the effectiveness of the internal control structure used in administering federal awards. Exhibit D-8 of appendix D of this SOP illustrates the report on program-related controls.

5.14. In addition to his or her responsibilities under SAS No. 55, the auditor should perform the following procedures regarding the internal control structure used in administering federal awards:

- Test the effectiveness of the design and operation of the internal control structure policies and procedures for preventing or detecting material noncompliance.
- Review the recipient's system for monitoring subrecipients and obtaining and acting on subrecipients' audit reports.
- Determine whether controls to ensure that direct and indirect costs were computed and billed in accordance with the general requirements are in place.
- Document procedures employed to assess and test the internal control structure.

5.15. A literal interpretation of Circular A-133 would require the auditor to perform tests of controls relevant to each federal program regardless of the dollar amount of the program expenditures. However, a somewhat different approach for considering the internal control structure, a description of which follows, has been developed in consultation with representatives of the OMB, the GAO, and the PCIE. The approach was originally developed for audits of state and local governmental units under Circular A-128, but it is considered acceptable under Circular A-133.

Major Programs

5.16. For each major program as defined in Circular A-133, the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that he or she considers relevant to preventing or detecting material noncompliance with—

a. Specific requirements that are applicable to those programs, addressing the types of services allowed or not allowed; eligibility; matching, level of effort, or earmarking; reporting; and special tests and provisions, as discussed in paragraphs 58 through 62 of SAS No. 68.

b. General requirements addressing civil rights, political activity, cash management, the Davis-Bacon Act, federal financial reports, allowable costs and cost principles, the Drug-Free Workplace Act, and certain administrative requirements. Paragraphs 46 through 49 of SAS No. 68 discuss these eight general requirements.

c. Requirements governing claims for advances and reimbursements, and amounts claimed for reimbursement or used for matching, as discussed in paragraph 59 of SAS No. 68.

d. Cost allocation and subrecipient monitoring, specifically identified in section 13(b)(2) of the Circular A-133 Attachment.

5.17. The auditor should consider the results of these tests of controls when evaluating control risk and developing substantive tests to provide a basis for expressing an opinion on compliance with laws and regulations applicable to major programs.

5.18. Tests of controls should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55. Tests of controls, which provide evidence of the design and operation of the controls and procedures, may include steps such as (*a*) inquiries of appropriate personnel, including grant and contract managers; (*b*) inspection of documents and reports; (*c*) observation of the application of the specific control policies and procedures; and (*d*) reperformance of the application of the policy or procedure by the auditor. The auditor should perform such procedures regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level.

5.19. Tests of controls may be omitted only in those areas where the internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance (in which case a reportable condition or material weakness should be reported) or in those areas that are not relevant to the compliance determinations discussed in paragraph 5.16.

5.20. For purposes of SAS No. 55, a reportable condition is a matter coming to the auditor's attention that, in his or her judgment, should be communicated to the audit committee (or its equivalent) because it represents a significant deficiency in the design or operation of the internal control structure that could adversely affect an organization's ability to record, process, summarize, and report financial data in a manner consistent with the assertions of management in the financial statements or to administer federal programs in accordance with applicable laws and regulations.

5.21. There may be separate control policies and procedures related to student financial assistance and research and development, which are treated as one program under a Circular A-133 audit. In this case, when evaluating whether an identified deficiency is a reportable condition, the auditor should consider the deficiency in relation to the program administered by the control policies and procedures being reviewed as well as the overall program. Some examples are as follows: (*a*) a significant deficiency in specific controls over a single SFA program with significant expenditures, time cards of college work study students, for example, would be considered a reportable condition when considered in relation to the college work study program; (*b*) significant deficiencies in controls over a single campus or department of a university where a significant amount of research was administered would be a reportable condition when considered in relation to total expenditures of R&D programs; (*c*) a deficiency in an SFA or R&D program that was clearly insignificant to SFA or R&D, respectively, as a whole would not necessarily be considered a reportable condition, and the auditor would report a finding in a separate letter.

5.22. A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more elements of the internal control structure does not reduce, to a relatively low level, the risk that either errors or irregularities in amounts that would be material to the financial statements being audited, or noncompliance with laws and regulations that would be material to a major federal program,[22] may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Nonmajor Programs

5.23. The auditor may find that the total amount of major program expenditures is less than 50 percent of a recipient organization's total federal cash and noncash award expenditures. In such circumstances, the auditor should select nonmajor programs (to reach 50 percent of federal expenditures) on a rotating basis so that all but clearly insignificant programs are covered at least once every three years. As an alternative, the auditor may perform tests of controls over all the major programs and the largest nonmajor programs until at least 50 percent of federal program expenditures have been subjected to tests of controls performed in accordance with paragraph 1.32 of this SOP.

5.24. For all other nonmajor programs, the auditor should, at a minimum, obtain an understanding of each of the three elements of the organization's internal control structure—the control environment, the accounting system, and control procedures—that he or she considers relevant in preventing or detecting material noncompliance with the requirements listed in paragraph 1.26 of this SOP. That understanding should include the design of relevant policies, procedures, and records, and whether the organization has placed them in operation. In obtaining this understanding, the auditor is not required to obtain knowledge about operating effectiveness.

5.25. If the recipient organization has no major programs, the scope of the auditor's consideration of the internal control structure used in administering federal award programs should be comparable to the scope applicable to major programs, as described in paragraphs 5.16 through 5.22 of this SOP, for the selected nonmajor programs that, in the aggregate, are equal to or greater than 50 percent of total federal program expenditures. The auditor's consideration of the internal control structure relating to the remainder of the federal programs need not exceed that described in paragraph 5.24 of this SOP.

Documentation Requirements

5.26. The auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures related to general and specific compliance requirements. The steps performed and conclusions reached should be clearly evidenced in the auditor's working papers. The working papers should clearly demonstrate the auditor's understanding and assessment of control risk related to the internal control policies and procedures established for federal awards. If the auditor has not performed tests of controls relevant to certain requirements or programs, as discussed in paragraph 5.19 of this SOP, then the rationale for omitting such tests should be documented.

Cyclical Approach

5.27. In some circumstances, such as when multiple operating components of an NPO administer a large number of nonmajor programs, the auditor may obtain the required understanding of internal control structure policies and procedures applicable to nonmajor programs on a cyclical basis over a number of years. For a cyclical approach to be acceptable, each nonmajor

[22] For this purpose, a material weakness would include such a condition that related to a major program or a program tested under the 50-percent rule set forth in paragraph 1.32 of this SOP.

program for which the cyclical approach is used should be covered at least once every three years. In the first year of the review cycle, the auditor should obtain an understanding of the internal control structure policies and procedures for all programs, except those that are clearly insignificant, about which he or she has not obtained an understanding. Also, the auditor should obtain an understanding of policies and procedures for all new nonmajor programs, except those that are clearly insignificant in the first year that the programs are active. The decision to use the cyclical approach should be discussed with the cognizant agency. If a cyclical approach is used, the auditor's report on the internal control structure should be modified to clearly describe the coverage provided for nonmajor programs.

5.28. These steps provide the basis for the report on program-related controls, which is illustrated in exhibit D-8 of appendix D to this SOP.

Chapter 6

COMPLIANCE AUDITING

Compliance Auditing Environment

6.1. The auditor should be aware of the unique characteristics of the compliance auditing environment. NPOs differ from commercial enterprises in that they may be subject to the diverse charitable intentions of their donors, who often restrict the use of their funds. Further, federal, state, and local governments have established various laws and regulations that affect NPOs' operations.

6.2. Although it is management's responsibility to identify and comply with relevant laws and regulations, the auditor should obtain an understanding of various compliance requirements and adequately train audit personnel. Paragraph 11 of SAS No. 68 discusses how the auditor may obtain an understanding of the effects of laws and regulations. Depending on the environment, auditors should consider including a description of the type of engagement in any proposal, contract, or engagement letter. Such a description would include statements about whether the engagement is intended to meet a cognizant agency's requirements.

6.3. A wide spectrum of compliance requirements may apply to NPOs. The requirements vary from state to state and among the several forms of NPOs. Appendix C of this SOP describes various approaches followed by state governments in establishing compliance requirements. The auditor should consider compliance requirements by consulting audit guides or other guidance relevant to the particular engagement.

The Auditor's Responsibility for Compliance Auditing in Accordance With GAAS

6.4. When performing an audit of an NPO in accordance with GAAS, auditors should consider the federal, state, and local laws and regulations that are generally recognized to have a direct and material effect on the determination of financial statement amounts.

6.5. SAS No. 68 describes the auditor's responsibility for considering laws and regulations and their effect on a GAAS audit. Paragraphs 6 and 7 of SAS No. 68 reiterate the auditor's responsibility for detecting misstatements caused by illegal acts, errors, and irregularities. Paragraph 8 states:

> Thus, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

Paragraphs 11 through 15 of SAS No. 68 describe the auditor's responsibility to understand the effect of laws and regulations and to consider the related audit risk.

6.6. According to SAS No. 68, the independent auditor of an NPO should—

- Assess whether management has identified laws and regulations, noncompliance with which could have a direct and material effect on the determination of amounts in the financial statements.
- Become familiar with those laws and regulations that could have a direct and material effect on financial statement amounts.

- Understand the characteristics of those laws and regulations that could, if they were not followed, potentially lead to a misstatement on the financial statements.
- Assess the risk that a material misstatement has occurred because of such noncompliance.
- Design and conduct an audit to provide reasonable assurance of detecting such material noncompliance.

6.7. It is management's responsibility to identify the compliance requirements of the NPO. The auditor should discuss these requirements with the organization's operating personnel, chief financial officer, and, if necessary, legal staff. Those discussions should focus on compliance matters included in laws and regulations, including the bylaws, that could, if not complied with, have a direct and material effect on the financial statements. If necessary, the auditor should contact a state auditor or an appropriate oversight body to obtain information about key areas of compliance applicable to the NPO, including state statutes, regulations, and uniform reporting requirements. In addition, the following approaches may be helpful in identifying compliance requirements:

- Obtain publications pertaining to federal tax and other reporting requirements, such as those of the Department of the Treasury and the Internal Revenue Service pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.
- Review materials available from other professional organizations, such as state societies of CPAs.
- Identify sources of revenue received by an NPO and inquire about restrictions, limitations, terms, and conditions under which such revenue is received. Review any related agreements (for example, loans and grants) and inquire about the applicability of any overall regulations of governments that apply to the accounting for the revenue.
- Obtain copies of and review pertinent sections of the state constitution and state laws concerning the organization. The sections of these documents pertaining to debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- Consider contacting the audit, finance, or program divisions of senior levels of government from which grants are received. They usually can be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.

6.8. In order to assess the risk of the possible nature of noncompliance with identified laws and regulations and the potential consequences, the auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in an entity's financial statements. Considerations may include: the materiality of the effect on financial statement amounts, the level of management or employee involvement in the compliance assurance process, the opportunity for concealment of noncompliance, and any deficiencies in the internal control structure.

6.9. Based on this risk assessment, the auditor should design the audit to provide reasonable assurance of detecting instances of noncompliance with identified laws and regulations that could have a direct and material effect on the financial statements. In all cases, the auditor should exercise due care and the proper degree of professional skepticism in planning, performing, and evaluating the results of audit procedures to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

6.10. Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his or her audit report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement exists in the financial statements is not, in and of itself, evidence of inadequate planning, performance, or judgment on the part of the auditor.

6.11. Paragraph 19 of SAS No. 68 notes that the auditor should consider obtaining, as part of the written representations from management required by SAS No. 19, *Client Representations,* representations from management acknowledging that—

a. It is responsible for the entity's compliance with laws and regulations applicable to it.

b. It has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts.

Illegal Acts—Indirect and Material

6.12. With respect to detecting and reporting illegal acts that do not directly relate to specific financial statement amounts, the auditor should be aware of the possibility that certain types of illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material, indirect effect on the financial statements, the auditor should apply audit procedures specifically directed at ascertaining whether an illegal act has occurred.

6.13. Examples of such illegal acts may include violations of occupational safety and health, environmental, food and drug, and price-fixing laws and regulations. Generally, these laws and regulations relate more directly to the nonfinancial operations of an NPO and, accordingly, have only an indirect effect on the financial statements. An auditor ordinarily does not have a sufficient basis for recognizing possible violations of such laws and regulations. Due to the indirect nature of such violations, an audit made in accordance with GAAS provides no assurance that these violations will be detected or that any contingent liabilities that may result will be disclosed. Examples of laws and regulations that fall into this category may include informational tax-reporting requirements and investment policies that, for social reasons, prohibit investments in organizations doing business in certain countries.

Compliance Auditing Requirements of *Government Auditing Standards*

6.14. While incorporating GAAS as described in paragraph 1.5 of this SOP, paragraph 5 on page 5-2 of *Government Auditing Standards* also requires that the auditor issue a *written* report on compliance with applicable laws and regulations that may have a direct and material effect on financial statement amounts. Paragraphs 20 through 30 of SAS No. 68 provide guidance on reporting on compliance with applicable laws and regulations.

Compliance Auditing Requirements of OMB Circular A-133

6.15. In addition to the requirements of GAAS and *Government Auditing Standards,* Circular A-133 requires that the auditor determine whether "the institution has complied with laws and regulations that may have a direct and material effect on its financial statement amounts and on each major federal program" (paragraph 12[b][3]).

Major Program Compliance

6.16. With regard to major programs, however, Circular A-133 requires that "the auditor obtain sufficient evidence to support an opinion on compliance" (paragraph 13[c][3]). As set forth in Circular A-133 and in SAS No. 68, the opinion should cover types of services allowed or not allowed (including, as set forth in the general requirements, compliance with the cost principles), eligibility of program beneficiaries, matching, federal financial reports, and special tests and provisions. The auditor should gain an understanding of the laws and regulations related to these aspects of major programs that is sufficient to assess the risk of material misstatement of program financial results.

6.17. In order to determine which federal awards are to be tested for compliance, recipients should identify in their accounts all federal funds received and expended and the programs from which they were received. This includes funds received directly from federal agencies and those passed through from state and local governments or other recipients. The auditor should test the recipient's identification of major programs.

6.18. In determining the nature, timing, and extent of testing of an organization's compliance with such requirements, the auditor should consider audit risk and materiality related to each major program. That is, in addition to testing compliance with laws and regulations that have a direct and material effect on the financial statements, the auditor should test compliance with laws and regulations that have a direct and material effect on each major program. This typically results in a lower level of materiality, since materiality is evaluated at the program level rather than at the financial statement level. The testing for compliance provides the basis for the auditor's opinion on compliance illustrated in exhibits D-4 through D-7 of appendix D to this SOP.

6.19. Once the NPO identifies major programs, the auditor designs an approach to testing the specific requirements that could have a direct and material effect on the results of each major program. The auditor generally tests the compliance requirements through the following:

a. Inquiry, observation, and testing at the organizational level

b. Procedures, including tests of transactions, directed at the major program level

6.20. The Compliance Supplements set forth compliance requirements regarded by federal agencies as having a potentially direct and material effect on major programs. The Compliance Supplements suggest audit procedures for testing federal programs for compliance with both the general and the specific requirements.

6.21. Audits under Circular A-133 include the selection and testing of an adequate number of representative transactions from each major federal program to provide sufficient evidence to support the auditor's opinion on whether the organization has complied, in all material respects, with the specific requirements applicable to each major program. In determining the number of items to select, the auditor should assess materiality in relation to the individual major program being tested rather than in relation to the major programs taken as a whole or in relation to the financial statements.

6.22. The extent of testing is based on the auditor's professional judgment regarding factors such as—

- The amount of expenditures for the program.
- The diversity or homogeneity of expenditures for the program.
- The length of time that the program has operated, or changes in its conditions.
- Prior experience with the program, particularly as revealed in audits and other evaluations (for example, inspections, program reviews, or system reviews required by the federal acquisition regulations).
- The extent to which the program is carried out through subrecipients.
- The extent to which the program contracts for goods or services.
- The level to which the program is already subject to program reviews or other forms of independent oversight.
- The results of the tests of adequacy of the controls for ensuring compliance.
- The expectation of adherence or lack of adherence to the applicable laws and regulations.
- The potential impact of adverse findings.

Nonmajor Program Transactions

6.23. The auditor should also consider samples selected during tests of the internal control structure and during the audit of the financial statements to identify nonmajor program transactions that will require further compliance testing.

6.24. For the issuance of a report on compliance with the specific requirements applicable to nonmajor program transactions, Circular A-133 requires that transactions selected from nonmajor federal programs be tested for compliance with the federal laws and regulations that apply to such transactions. For example, selection of nonmajor program transactions may occur during an auditor's organization-wide test of payroll or disbursement transactions. If the auditor has selected nonmajor transactions, they should be tested for compliance with the specific requirements that apply to the individual transactions and be reported on in accordance with exhibit D-18 of appendix D to this SOP. If no tests are made of transactions from nonmajor programs, no report is required.

6.25. The specific requirements for which nonmajor program compliance should be tested customarily relate to the allowability of the program expenditure and the eligibility of the individuals or groups to whom the NPO provides federal awards. If the auditor selects a transaction from a nonmajor program in the financial statement or internal control work, it is not expected that the general requirements will be tested. For example—

- If, in the audit of the financial statements, the auditor examined a payroll transaction that was directly charged to a nonmajor program, he or she should determine that the position could reasonably be charged to that program and that the individual's salary was correctly charged to that program. (The auditor would not be required to test the transactions for compliance with general requirements, for example, civil rights or cash management requirements.)

- If, during the audit of the organization's disbursements, the auditor examined a travel claim that was directly charged to a nonmajor program, he or she should examine evidence indicating whether the person who performed the travel worked on the program, whether the purpose of the travel was related to the program, whether administrative travel was an allowable charge to the program (for example, whether it complied with the Fly America Act), and whether the travel allowance was within administratively prescribed limits. (The auditor would not be required to test the transactions for compliance with general requirements, for example, civil rights or cash management requirements.)
- If the auditor examined a program-related payment made directly to an individual or organization, he or she should determine whether the payment was for the purpose intended by the program and for services allowed by the program and whether the individual or organization was eligible. (The auditor would not be required to test the transaction for compliance with general requirements, for example, civil rights or cash management requirements.)

Audit Sampling for Major Federal Programs

6.26. As noted above, Circular A-133 requires the auditor to select and test a sufficient number of transactions to support an opinion on compliance with specific requirements related to each major program. Although the term sampling is not mentioned, independent accountants often perform audit sampling to achieve this objective. SAS No. 39, *Audit Sampling,* discusses the factors to be considered in planning, designing, and evaluating audit samples. In addition, the AICPA Audit and Accounting Guide, *Audit Sampling,* provides detailed guidance to assist auditors in implementing SAS No. 39. Both documents discuss the use of audit sampling for tests of controls and for substantive tests of details of account balances or classes of transactions.[23]

6.27. Although Circular A-133 does not require statistical sampling, it does require that a "representative number of transactions be selected from each major federal financial assistance program." Auditors should use professional judgment in determining sample selection methods and sample sizes for major programs sufficient to support an opinion on compliance with applicable laws and regulations relative to each major program.

6.28. The objectives of auditing procedures for federal awards are to provide sufficient, competent evidential matter to provide reasonable assurance of detecting material noncompliance with specific requirements applicable to major federal award programs and issue a report containing either an opinion on compliance with these requirements or a statement that such an opinion cannot be expressed. The testing to obtain those objectives is substantive. Based on the auditor's assessment of control risk, the auditor should select

[23] The U.S. Department of Education's *Audits of Student Financial Assistance Programs* (the Education Audit Guide) specifies testing procedures and sample sizes.
For a Circular A-133 audit, the Education Audit Guide procedures and sample sizes are not required, but the auditor may use them as guidance. However, if the entity elects to have a program audit because it has only one program or it received less than $100,000 in federal awards, the auditor must follow the guidance on testing in the Education Audit Guide.

sample sizes that will provide sufficient evidence for a conclusion on the NPO's compliance with the specific requirements applicable to each major program. The auditor's professional judgment should be used when selecting sample sizes. However, when exercising that judgment, the auditor should be aware that samples of a few items with a low dollar value from a large population will probably not be sufficient to enable the auditor to express an opinion concerning compliance.

6.29. OMB Circular A-133 requires that an adequate number of transactions be selected from each major program, but it does not require that separate samples be used for each major program. Experience has shown, however, that it is generally preferable to select separate samples from each major program, since the separate sample clearly provides evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate (*a*) that a sample was selected from each major program and (*b*) that the results of tests of such samples, together with other audit evidence, are sufficient to support the opinion on *each* major program's compliance with the specific requirements.

Materiality Considerations

6.30. In auditing compliance with specific requirements governing major programs in accordance with OMB Circular A-133, the auditor's consideration of materiality differs from that in an audit of financial statements in accordance with GAAS. In an audit of an NPO's financial statements, materiality is considered in relation to the financial statements being audited. In an audit of an organization's compliance with specific requirements governing major programs in accordance with Circular A-133, however, materiality is considered in relation to *each* major program to which the transaction or finding relates. Although Circular A-133 and the Compliance Supplement require the auditor to test particular specific and general requirements, the auditor should apply the concept of materiality to each major program, taken as a whole, rather than to each individual requirement. If the tests of compliance reveal a material misstatement at the program level, the auditor should consider its effect on the financial statements.

6.31. For purposes of assessing compliance with laws and regulations governing federal awards in the performance of an organization-wide audit under Circular A-133, a material instance of noncompliance is defined as a failure to follow requirements, or a violation of prohibitions, established by statutes, regulations, contracts, or grants, that results in an aggregation of misstatements (that is, the auditor's best estimate of the total misstatement) that is material to the affected federal award program.

6.32. *Government Auditing Standards* (page 3-13) states that, in determining whether a compliance finding is material, the auditor should consider *both* quantitative (monetary value) and qualitative factors. Qualitative factors include, but are not limited to, the cumulative effect and impact of immaterial items, the objectives of the work undertaken, and the use of the reported information by the user or groups of users of the information. Decisions on these criteria are based on the auditor's professional judgment. In government audits, the materiality level and/or threshold of acceptable risk may be lower than in similar type audits in the private sector because of the public accountability of the entity, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.

6.33. Qualitative factors indicating an immaterial compliance finding are a low risk of public or political sensitivity, a single exception with a low risk of being pervasive, and the auditor's judgment and experience are that federal agencies or prime recipients would normally not need to resolve the finding or take follow-up action, or that the cost of recovery would exceed the amount of the finding.

6.34. Because the auditor expresses an opinion on *each* major program and not on all the major programs combined, reaching a conclusion about whether the instances of noncompliance (either individually or in the aggregate) are material to a major program requires consideration of the type and nature of the noncompliance as well as the actual and projected effect on each major program in which the noncompliance was noted. Instances of noncompliance that are material to one major program may not be material to a major program of a different size or nature. In addition, the level of materiality relative to a particular major program can change from one period to another. Finally, an error in one period may not be material to a two-year period being audited under the biennial option in Circular A-133.

6.35. The auditor should follow a process such as the following in deciding how to report instances of noncompliance for major programs and whether to include them in his or her report on compliance or in a separate communication to management:

a. If the noncompliance is not significant (i.e., it does not meet the criteria for materiality discussed in paragraph 6.32 of this SOP in relation to the specific requirements), the auditor may report the finding in a separate communication to management.

b. If the noncompliance is significant, the auditor should assess whether it is material to the major program being tested taken as a whole.

c. If the noncompliance is material to the major program, the auditor should modify his or her report on compliance.

d. If the auditor's assessment is that the noncompliance is material to the specific requirement, but not material to the major program being tested as a whole, the auditor should disclose the matter in his or her report as a finding or questioned cost and not in a separate communication to management.

Compliance Testing—Specific Requirements

6.36. The auditor is required to perform sufficient work to render an opinion on whether—

a. The amounts reported as expenditures were for allowable services.

b. The records show that those who received services or benefits were eligible to receive them.

c. Matching requirements, levels-of-effort, and earmarking limitations were met.

d. Federal financial reports *and* claims for (1) advances and (2) reimbursements contain information that is supported by the books and records from which the general-purpose or basic financial statements were prepared.

e. Amounts (1) claimed for reimbursement or (2) used for matching were determined in accordance with the cost principles and matching or cost-sharing requirements set forth in (*a*) Circular A-21; (*b*)

Circular A-110; (*c*) Circular A-122; (*d*) Federal Acquisition Regulation (FAR), subpart 31, cost principles; and (*e*) other applicable cost principles or regulations. It also may be necessary to refer to HHS OASC-3, *Cost Principles for Hospitals.*

f. Special tests and provisions where federal agencies have determined noncompliance could materially affect the program. (For example, some agencies set a deadline for the expenditure of federal financial assistance or require that all international travel be performed in accordance with the Fly America Act.) In addition, when auditing a major student financial aid program at an educational institution, an auditor would typically perform compliance testing of the laws and regulations of the Department of Education as specified in the Compliance Supplement relating to the eligibility of participants, the calculation of awards, and exercise of due diligence in the collection of loans.

Allowable Costs and Cost Principles

6.37. Transactions selected by the auditor from each major program should be tested to determine whether the costs meet the criteria of the cost principles that apply to each program. The auditor's working papers should document the applicable criteria reviewed, the results of the audit work performed, and the conclusion reached by the auditor.

6.38. The cost principles set forth in Circulars A-21 and A-122, FAR subpart 31, and HHS OASC-3 establish standards for determining costs applicable to grants, contracts, and other agreements. Costs are allowable for federal reimbursement only to the extent of benefits received by the federal programs. To be eligible for federal reimbursement, both direct and indirect costs should meet the criteria generally contained in the Basic Considerations section of the applicable cost principles. These criteria require that the cost be—

- Necessary and reasonable for the performance and administration of the federal program and allocable thereto under the provisions of the cost principles.
- Authorized or not prohibited under state or local laws or regulations and approved by the awarding agency, if appropriate. Certain costs require specific approval by the grantor agency, while some are not allowed as set forth in the section of the applicable cost principles dealing with Selected Items of Costs.
- In conformance with any limitations or exclusions set forth in the applicable cost principles, or with any limitations in the program agreement or specific requirements in the program regulations.
- Given consistent treatment with policies, regulations, and procedures applied uniformly to federal and nonfederal activities of the recipient organization.
- Given consistent accounting treatment within and between accounting periods and not allocable to, or included as a direct cost of, a federal program if the same or similar costs are allocated to the federal program as an indirect cost.
- Determined in accordance with generally accepted accounting principles or another comprehensive basis of accounting.

- Not included as a cost or used to meet cost-sharing requirements of another federally supported activity of the current or a prior period.
- Allocable to the federal awards. The charges should be allocable to a particular cost objective, such as a grant, project, or other activity, in accordance with the relative benefits received. A cost is allocable to a federal award if it (*a*) is incurred specifically to advance the work under the award; (*b*) benefits both an award and other work and can be distributed in an equitable manner in relation to benefits received; (*c*) is necessary to the overall operation of the organization; and (*d*) is otherwise allowable under the cost principles provided in HHS OASC-3, if applicable, and OMB Circulars A-21 and A-122. An allocable cost of an award or other cost objective may not be shifted to other federal awards to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms of an award.
- Net of all applicable credits, for example, volume or cash discounts, refunds, rental income, trade-ins, scrap sales, direct billings (in the case of indirect cost), etc.
- Supported by underlying documentation, for example, time and attendance payroll records, personnel activity reports or other time and effort records for employees charged to federal awards or to more than one activity, approved purchase orders, receiving reports, vendor invoices, canceled checks, etc., as appropriate, and correctly charged as to account, amount, and period.

6.39. There should be an advance understanding for special or unusual costs. The reasonableness and allocability of certain items of costs may be difficult to determine. Should such costs be disclosed during the audit, the auditor should determine whether the organization had an advance understanding about whether the costs would be considered allowable. The understanding should preferably be in writing and approved by the awarding or cognizant agency in advance of the expenditure; otherwise the costs may be disallowed.

6.40. If subject to prior approval in accordance with HHS OASC-3, OMB Circulars A-21 or A-122, or the terms of the award, the charges should be approved in advance. OMB Circulars A-21 and A-122 and HHS OASC-3 indicate that prior approval is required for specific types of expenditures, such as for the purchase of equipment and for foreign travel. In addition, an award agreement may require advance approval for other specific costs.

Indirect Costs

6.41. In addition to federal reimbursement for direct program costs, NPOs often receive reimbursement for indirect costs or for the costs of centralized services. To obtain reimbursement, NPOs generally should establish a basis for allocating such costs to federal programs by preparing a cost allocation plan or an indirect-cost rate proposal. Cost allocation plans and/or indirect-cost rate proposals can differ significantly between large and smaller not-for-profit organizations. For example, one of the most basic differences is that most large organizations have multiple missions, while the missions of smaller NPOs are more narrowly focused. These multiple missions of large organizations may benefit from indirect costs in a variety of ways. These costs are usually allocated on a multiple allocation-base method—a method in which the use of cost pools may obscure the details of what costs are actually included in the cost pools.

6.42. *Smaller Entities.* Small NPOs usually have missions that benefit equally from indirect costs. For these NPOs, the allocation of indirect costs may be accomplished by separating the entity's total costs as either direct or indirect costs and dividing the total allowable indirect cost by an equitable distribution base to arrive at an indirect-cost rate. By reviewing a schedule of the costs included in the direct and indirect areas it is usually possible to identify the major unallowable or inappropriate costs. To assess the allowability of such indirect costs, the auditor should refer to procedures set forth for indirect costs in the general requirements section of the Compliance Supplements. Auditors should note that, although an opinion specifically related to the allocation of indirect costs is not required, allowability of total costs is one of the specific requirements on which the auditor opines.

6.43. *Compliance Requirement (Indirect Costs Only).* The NPOs indirect-cost rate proposal provides the basis for allocating indirect costs to federal programs and for negotiating an indirect-cost rate. Circulars A-88 and A-122 provide for cognizance systems whereby one federal agency is designated as the cognizant agency to deal with a college, university, or nonprofit organization on behalf of the entire federal government and to negotiate indirect-cost and other rates, which are used by all other federal agencies in dealing with that recipient organization. In most cases, therefore, proposals are submitted to an appropriate cognizant agency.

6.44. Proposals are usually prepared on a prospective basis using actual financial data from a prior period or budgeted data for the current year. When the actual costs for the year are determined, the differences between the originally proposed costs and the actual costs for the year are either carried forward to a subsequent period's rate or adjusted with the granting federal agency on a retroactive basis. In cases where predetermined rates are determined and approved by the cognizant federal agency, subsequent adjustments are not made, with the exception of eliminating any unallowable costs. Audit procedures must be tailored according to the type of rate and size and type of organization being audited. If unallowable costs are found, cost recoveries and adjustments should be made in accordance with the provisions of the applicable cost principles.

6.45. *Universities.* Indirect costs are apportioned between research and the other major functions of a university, such as instruction, other sponsored activities, and other institutional activities, based on various allocation procedures prescribed in Circular A-21. That portion of indirect costs identified with research is then further distributed to individual research projects by an indirect-cost rate(s). Where necessary, an indirect-cost rate is also established for the instruction function and for Other Sponsored Programs.

6.46. Indirect costs at large educational institutions are normally classified in the following categories: (*a*) building and equipment depreciation/use allowances, (*b*) operation and maintenance expenses (including utility expenses), (*c*) general administration expenses, (*d*) departmental administration expenses, (*e*) sponsored projects administration expenses, (*f*) library expenses, and (*g*) student administrative services expenses.

6.47. Currently, most large universities use a predetermined indirect-cost rate. This rate is negotiated in advance for future years (normally a three-year period) based upon a proposal that uses costs from a prior year. An example would be a university that has a negotiated predetermined indirect-cost rate with no provision for carryover for the three fiscal years 1989, 1990, and 1991. Usually, the indirect-cost proposal would be prepared in fiscal year 1991 using fiscal year 1990 costs and would be the basis for the indirect-cost rates in fiscal years 1992, 1993, and 1994. The audit of the 1990 fiscal year would include testing the indirect-cost proposal that was prepared using 1990 data. The next indirect-cost proposal required to be submitted by the institution would use fiscal year 1993 costs and be submitted within six months of the end of fiscal year 1993. In this example, there is no requirement that an indirect-cost proposal be submitted for fiscal years 1991, 1992, and 1994.

6.48. An auditor engaged to audit fiscal year 1991, 1992, or 1994 would not be required to audit the indirect-cost proposal, as none was required to be submitted. However, the auditor for the years when a proposal was not required to be submitted would be required to test the financial systems that will be used in preparing future indirect-cost proposals. Examples of such systems are those for equipment and fixed assets, and those used in classifying expenditures. An auditor would also be concerned that costs treated as indirect in the negotiating process were not being charged as direct costs. This would require an understanding of the previous proposal. If the auditor finds any unallowable costs that were included in a proposal (whether in the current proposal or in a previous proposal on which the 1991, 1992, or 1994 rate was based), these costs should be questioned.

6.49. If a predetermined indirect-cost rate with no provisions for carry-over has been negotiated for the year under audit, the opinion on whether costs claimed are allowable would be related to the application of the negotiated rate. The indirect-cost proposal that is the basis for claiming costs in future years would be tested as a general requirement. In cases where the negotiated rate is provisional or has a carry-forward provision, the indirect-cost proposal would affect the specific requirement related to the allowability of costs.

6.50. *Procedures for Indirect Costs.* The Circular A-133 Compliance Supplement sets forth the following procedures for audits of indirect costs. These procedures may be modified for smaller entities.

a. Determine whether indirect costs are charged to federal awards. If not, the rest of this section does not apply. If such costs are charged, the following guidelines should be followed.

b. Obtain and read the current negotiation agreement, as well as any agreements, conditions, or understandings related thereto, and determine the types of rates and procedures required.

c. Select a sample of claims for reimbursement submitted to the federal agency and determine whether the amounts charged and rates used are in accordance with agreements, and whether rates are being properly applied to the appropriate base.

d. Determine whether the rates used or amounts charged are final or predetermined, or whether they are still open to adjustment or revision, either immediately or as a carry-forward adjustment in a future period. If final, the results of the audit work should be reflected, if appropriate, in recommendations for future procedural improvements. However, if the final or predetermined rates include unallowable costs, they should be identified and reported along with the estimated federal share of the costs.

e. Determine whether costs or types of costs, chargeable directly to federal awards or any other direct activity (including any costs required for matching or cost changing), have been eliminated from the pool of indirect-costs and included in the allocation or rate base.

f. Determine whether the established procedures to identify and eliminate unallowable costs are comprehensive and applied in a consistent manner. Verify that the results of these procedures are incorporated into the indirect cost proposal submitted to the cognizant agency.

g. Test supporting documentation to determine whether—

— The indirect-cost pools contain only items that are consistent with the applicable cost principles and negotiated agreements. This testing should be aimed at determining whether the indirect-cost pools contain any unallowable costs, as defined by the cost principles (e.g., entertainment, lobbying, etc.).

— The methods of allocating the costs are in accordance with the provisions of the appropriate cost principles, other applicable regulations, and negotiated agreements and produce an equitable distribution of costs.

— Statistical data (e.g., square footage, population or full-time equivalents, salaries and wages) in the proposed allocation bases are current, reasonable, updated as necessary, and do not contain any material omissions.

— Personnel activity reports, time and effort reports, or other methods used to allocate salary and wage costs are mathematically and statistically accurate, are implemented as approved, and are based on the actual effort devoted to the various functional and programmatic activities to which the salary and wage costs are charged.

— Special costs analysis studies (such as library studies or energy studies) are mathematically and statistically accurate, are factually based to the extent possible, use reasonable and supportable assumptions, produce reasonable results, and, if appropriate, agree with any prior agreements with, or conditions placed by, the cognizant agency concerning such studies.

— The data can be reconciled with the most recently issued financial statements. Investigate significant reconciling items.

Other Testing Considerations

6.51. As noted above, the Compliance Supplement contains suggested audit procedures that, if completed by the auditor, constitute a safe harbor, that is, such procedures are deemed to meet OMB and grantor agency audit expectations. PCIE Position Statement No. 6, Question 63, states that, "for programs contained in a Compliance Supplement which have not had subsequent changes, an audit of the requirements contained in the Compliance Supplement will meet the A-133 single audit requirements." Although each requirement appearing in the Compliance Supplements is accompanied by suggested audit procedures that can be used to test for compliance with laws and regulations, the auditor is not restricted to the use of only these audit procedures. The auditor should use professional judgment in determining the appropriate audit procedures.

6.52. An auditor may also be engaged to test and report on compliance with state and local laws and regulations. Paragraphs 98 and 99 of SAS No. 68 provide guidance on the auditor's responsibilities in these circumstances. Although Circular A-133 does not specifically address auditing compliance requirements for state or local government grants, state or local assistance may be covered by a state's audit requirement. Such a requirement may specify compliance tests, similar to those set forth in Circular A-133, to be performed at the option of the local government or in accordance with state law. When this is the case, auditors should consult state or local government officials or other sources concerning the nature and scope of required testing. However, state or local government funds provided to NPOs should be distinguished from state or local pass-throughs of federal funds. The latter pass-through funds are considered part of the federal awards received by the local recipient when conducting an audit in accordance with Circular A-133.

Compliance Testing—General Requirements

6.53. The Compliance Supplements identify general requirements for which the auditor should test compliance in all Circular A-133 audits. According to SAS No. 68, the auditor should test for compliance with general requirements whether or not the NPO has major programs. The auditor is not expected to express an opinion on an NPO's compliance with the general requirements. However, two general requirements (i.e., allowable costs and federal financial reports) are also included in the opinion on specific requirements as noted in Circular A-133. Rather, as illustrated in exhibit D-15 of appendix D to this SOP, the report provides positive and negative assurance and sets forth procedures and material findings. The general requirements are described in the following paragraphs.

6.54. *Political Activity.* The Hatch Act and the Intergovernmental Personnel Act of 1970, as amended, specify that federal funds cannot be used for political activity of any kind.

6.55. *Davis-Bacon Act.* When required by applicable legislation, construction programs are required to follow the provisions of the Davis-Bacon Act, which in general requires wages of laborers and mechanics employed by contractors of federally funded projects to be no lower than the prevailing regional wage rate as established by the Secretary of Labor.

6.56. *Civil Rights.* Federal programs provide that no person shall be excluded from participation or be subjected to discrimination in any program funded, in whole or in part, by federal funds because of race, color, national origin, sex, age, or physical impairment.

6.57. *Cash Management.* Many recipients receive funds through a letter-of-credit arrangement with the grantor agency. Cash should be withdrawn only in amounts necessary to meet immediate needs or to cover program disbursements already made.

6.58. *Federal Financial Reports.* Attachment H of Circular A-110 specifies that recipients of federal awards should file the financial reports for each federal award program. Paragraphs 6.62 through 6.65 below discuss the review of federal financial reports.

6.59. *Allowable Costs and Cost Principles.* These principles prescribe the direct and indirect costs allowable for federal reimbursement.

6.60. *Drug-Free Workplace.* This law prescribes that organizations certify that they provide a drug-free workplace (see paragraph 6.66).

6.61. *Administrative Requirements.* These prescribe administrative requirements that should be followed (see paragraph 6.67).

Review of Federal Financial Reports

6.62. In connection with tests of compliance with applicable laws and regulations, Circular A-133 states that the auditor should determine whether the "federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared. . . ." The Compliance Supplements require the auditor to determine if the federal financial reports are presented in accordance with Attachment H, "Financial Reporting Requirements," of Circular A-110.

6.63. The auditor should compare the statement of expenditures incurred under federally sponsored programs, as shown on the Schedule of Federal Awards, with the books and records of the organization and, as a part of his or her testing of control policies and procedures used in administering federal awards, compare the books and records with periodic financial reports to the federal government for tested items. This requirement has generally been interpreted to mean that federal financial reports are traceable to the recipient's financial records, that is, they are not based on estimates.

6.64. Attachment H describes the following reports that recipients should prepare, if applicable, and submit to the federal government:

- A financial status report
- A federal cash-transactions report
- A request for advance or reimbursement
- An outlay report and a request for reimbursement for construction programs

6.65. Individual federal award agreements may include the specific reporting requirements to be followed by the recipient. However, Attachment H establishes the standard financial-reporting requirements for all federal awards programs. When auditing a subaward or a state award or program, the auditor would also test financial reports submitted to the prime recipient or state.

Drug-Free Workplace

6.66. Direct recipients of grants and cooperative agreements from any federal agency are required to certify that they will provide a drug-free workplace as a precondition for receiving the grants. All grantees, except states, are required to make this certification for all grants. States, including state agencies, may elect to make an annual certification to each federal agency from which they obtain financial assistance. This requirement also applies to contractors that have contracts of $25,000 or more with the federal government. PCIE Position Statement No. 6, Question 68, states that the requirement does not, however, extend to subrecipients, unless the subgrantor (primary recipient) requires compliance with Drug-Free Workplace Act requirements. The federal government does not make this requirement.

Administrative Requirements (OMB Circular A-110)

6.67. Circular A-110 includes various administrative requirements with which NPOs should comply.[24] The requirements of Circular A-110 apply to federal awards in the form of grants and cooperative agreements. Federal awards in the form of entitlements generally are granted to states and passed through to NPOs. Such awards would be subject to the terms of the subaward

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[24] The OMB Compliance Supplement for Institutions of Higher Education and Other Non-Profit Institutions contains specific procedures for—

- Financial reporting.
- Cost principles.
- Cash management.
- Program income.
- Procurement.
- Property management.

as well as Circular A-110. Contracts are covered by their own terms and conditions.[25]

Other General Requirement Testing Considerations

6.68. The Compliance Supplements suggest procedures that can be performed to test an organization's compliance with the general requirements; however, the application of the Compliance Supplements' procedures is only recommended, not required. It has become generally accepted that the nature of these procedures is sufficient to satisfy the requirements of Circular A-133 with respect to the general requirements.

6.69. The auditor should issue a report on compliance with general requirements regardless of whether the NPO being audited has major programs. Determining the extent of any tests of compliance with general requirements is a matter of professional judgment. Among the matters the auditor considers are the extent of any tests of compliance with general requirements performed for major programs. If the NPO being audited has no major programs, the auditor should consider whether his or her tests of controls over compliance with general requirements provide evidence that would also support a report on compliance. If the tests of controls do not provide sufficient evidence to support a report on compliance, additional procedures to test compliance with the general requirements would need to be performed.

6.70. Many organizations receive federal awards from several federal agencies and, consequently, develop uniform controls and procedures over all federal programs. In relation to general requirements, however, many organizations may not formally document their administrative controls and procedures, since they are considered to be requirements that are unrelated to the determination of financial statement amounts. To identify the established controls and procedures for these general requirements, the auditor normally makes inquiries of key personnel of the organization, including grant managers. The auditor may also identify these controls and procedures by reviewing policy and procedure manuals, if any exist, and by observing the general workplace of the organization. The auditor's report on the general requirements is described in paragraph 7.25 and illustrated in exhibit D-15 of appendix D to this SOP.

Evaluation of Noncompliance

6.71. The auditor's tests of compliance with laws and regulations may disclose instances of noncompliance or questioned costs. Under Circular A-133, material instances of noncompliance and questioned costs should be reported in a schedule of findings and questioned costs and reported as discussed in paragraphs 7.30 through 7.32 of this SOP. The auditor may describe immaterial findings in a separate letter to the organization or include them with the report covering material instances of noncompliance. Paragraph 15 of the Attachment to Circular A-133 requires management to submit a copy of the letter covering immaterial instances of noncompliance to the federal grantor agencies or subgrantor sources. Although the auditor may issue as many as four different compliance reports in an organization-wide audit, findings and questioned costs may be presented in one schedule.

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[25] PCIE Position Statement No. 6, Question 67, states that, "since program income will normally be included in Federal financial reports, the auditor should consider program income in determining whether Federal financial reports contain information that is supported by books and records from which the basic financial statements are prepared. The auditor's responsibility for program income, as it relates to internal controls and compliance testing, is the same as that for program expenditures."

6.72. When instances of noncompliance with general requirements are identified and can be quantified, materiality is generally assessed at the program (or programs) level to which the noncompliance relates, and a determination to modify the auditor's report should be made at that level. However, when the noncompliance is not quantifiable (for example, failure to adopt a drug-free workplace policy), materiality is generally assessed at the financial statement level, that is, the auditor should consider the effect of any contingent liability in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies.*

6.73. The level at which materiality is assessed is critical in assessing whether a modification to the unqualified auditor's report is needed. In determining whether such a modification is needed, the auditor should—

a. Assess the actual error noted against the materiality level established for the individual program.

b. Assess the projected error against the materiality level established for the individual program.

6.74. If the auditor determines that the actual error is material to the individual program, depending on the circumstances, the auditor's report should be modified as illustrated in appendix D of this SOP. If the projected error is material to the individual program, the auditor should consider whether additional audit procedures should be applied.

6.75. Auditors also have the responsibility of assessing the impact of the actual and projected error noted in the testing on the financial awards programs against the materiality level established for the basic financial statements. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* paragraph 31, states:

> If the auditor concludes, based on his or her accumulation of sufficient evidential matter, that the aggregation of likely misstatements causes the financial statements to be materially misstated, he should request management to eliminate the material misstatement. If the material misstatement is not eliminated, he should issue a qualified or adverse opinion on the financial statements.

6.76. Guidance on qualified audit reports is provided in chapter 7 of this SOP. Circular A-133 does not require that the auditor's report on compliance include a projection of questioned costs to the universe of federal programs, nor does it require that the auditor expand the scope of an audit to determine with greater precision the effect of any questioned costs. However, there may be instances in which the circumstances of specific questioned costs could establish a basis for the auditor, the grantor, or both to question all costs charged to a federal program or programs. For example, if eligibility requirements or matching or cost-sharing conditions have not been met by the recipient, the entire amount expended in connection with affected programs may be questioned. If such questioned costs are subsequently disallowed by the federal agency, the entire amount may be required to be refunded by the recipient. The auditor should consider the effect of the liability or contingent liability on the basic financial statements. FASB Statement No. 5 provides guidance on accruing and disclosing contingent liabilities.

6.77. The auditor is required by Circular A-133 to identify the total amounts of questioned costs, if any, for each federal award as a result of noncompliance, and to recommend any necessary corrective action. The auditor's designation of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances, the auditor is unable to determine whether a federal grantor agency will ultimately disallow a questioned cost, because the grantor has considerable discretion in these matters. The nature of the questioned costs, as well as the amounts involved, are considered by the grantor in deciding whether to disallow them. Most federal grantor agencies have established appeal and adjudication procedures for questioned costs.

6.78. The auditor should evaluate the effect of reportable conditions and noncompliance on all of the reports required by Circular A-133.

Reporting Illegal Acts

6.79. Circular A-133 requires the auditor to report any illegal acts as set forth in *Government Auditing Standards.*

6.80. *Government Auditing Standards* requires that any illegal acts or indications of illegal acts be reported in the compliance report or in a separate report (see paragraphs 31 and 32 of SAS No. 68). Pages 5-4 through 5-6 of *Government Auditing Standards,* particularly paragraphs 5-13 and 5-16, discuss the appropriate parties who should be informed of illegal acts. (Paragraphs 7.17 and 7.18 of this SOP discuss illegal acts.)

Findings and Questioned Costs

6.81. *Government Auditing Standards* defines a finding as the "result of information development—a logical pulling together of information about an organization, program, activity, function, condition, or other matter which was analyzed or evaluated." It also states that factual data supporting all findings should be presented accurately and fairly in the auditor's report and that these findings should be adequately supported by sufficient evidence in the working papers.

6.82. When performing an audit in accordance with GAAS, the auditor should consider the effect of any instance of noncompliance on the financial statement opinion. When auditing in accordance with *Government Auditing Standards,* the auditor is required to issue a report on the results of the auditor's testing of compliance with laws and regulations at the general-purpose financial statement level. Also, the auditor is required by Circular A-133 to issue reports on compliance with requirements applicable to federal awards. Chapter 7 of this SOP describes these reporting requirements. Appendix D of this SOP includes illustrative compliance reports.

Criteria for Questioning Costs

6.83. The criteria established for questioning costs that are to be reported in the compliance report vary from one agency to another. Many of the criteria are imposed by Congress at the time the programs are authorized and funds are provided; other criteria are established through agency regulations. Generally, the criteria for reporting questioned costs relate to the following:

- *Unallowable costs.* Certain costs specifically unallowable under the general and special award conditions or agency instructions, including, but not limited to, pre-grant and postgrant costs and costs in excess of the approved grant budget, either by category or in total.
- *Undocumented costs.* Costs charged to the grant for which adequate detailed documentation does not exist (for example, documentation demonstrating their relationship to the grant or the amounts involved).

- *Unapproved costs.* Costs that are not provided for in the approved grant budget, or for which the grant or contract provisions or applicable cost principles, require the awarding agency's approval, but for which the auditor finds no evidence of approval.
- *Unreasonable costs.* Costs incurred that may not reflect actions that a prudent person would take in the circumstances, or costs resulting from in-kind contributions to which unreasonably high valuations have been assigned.

The auditor should review prior audit reports and other related correspondence to determine the nature of previous findings and questioned costs, as well as the status of unresolved issues. (See paragraphs 7.30 through 7.32 for further discussion of findings and questioned costs.)

Client Representations—Audits Performed Under OMB Circular A-133

6.84. Paragraph 91 of SAS No. 68 states that the auditor should obtain certain written representations from management as part of an audit conducted to express an opinion on compliance with requirements that have a material effect on a federal award program. Representations that should ordinarily be obtained in an organization-wide audit include the following:[26]

a. Management has identified in the schedule of federal awards all awards provided by federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations.

b. Management has identified the requirements governing political activity, the Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, federal financial reports, allowable costs/cost principles, drug-free workplace, and administrative requirements over federal awards.

c. Management has identified the requirements governing the types of services allowed or not allowed: eligibility; matching, level of effort, or earmarking; special provisions; reporting; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major programs, which are identified in the schedule of federal awards.

d. Management has complied, in all material respects, with the requirements in connection with federal awards except as disclosed to the auditor.

e. Information presented in federal financial reports and claims for advances and reimbursements are supported by the books and records from which the basic financial statements have been prepared.

f. Amounts claimed for reimbursement or used for matching were determined in accordance with OMB and agency requirements.

g. Management has monitored subrecipients to determine that they have expended financial assistance in accordance with applicable

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[26] These representations may be added to a representation letter obtained in connection with an audit of financial statements instead of obtaining a separate letter.

laws and regulations and have met the requirements of Circular A-133 or other applicable federal audit requirements.

h. Management has taken appropriate corrective action on a timely basis after receipt of a subrecipient's auditor's report that identifies noncompliance with federal laws and regulations.

i. Management has considered the results of the subrecipient's audits and made any necessary adjustments to the entity's own books and records.

j. Management has identified and disclosed to the auditor all amounts questioned, any known noncompliance with requirements that could have a material effect on a major program, and any other known noncompliance with the specific and general requirements of federal awards.

k. Management is responsible for complying with requirements in Circular A-133.

l. Management has disclosed all contracts or other agreements with the NPO's service organization.

m. Management has disclosed to the auditor all communications from the NPO's service organization relating to noncompliance at the NPO's service organization.

n. Management has disclosed whether, subsequent to the date as of which compliance is audited, any changes in the internal control structure or other factors that might significantly affect the internal control structure, including any corrective action taken by management with regard to reportable conditions (including material weaknesses), have occurred.

6.85. Management's refusal to furnish written representation constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on the institution's compliance with Circular A-133 requirements. Further, the auditor should consider the effects that management's refusal will have on his or her ability to rely on other management representations.

Chapter 7
REPORTING

Chapter Overview

7.1. *Government Auditing Standards* and OMB Circular A-133 broaden the auditor's responsibility to include reporting not only on an organization's financial statements but also on its internal control structure and its compliance with laws and regulations. This chapter presents the required compliance reports and the auditor's consideration of the internal control structure in audits performed in accordance with *Government Auditing Standards* and in those performed in accordance with Circular A-133. A pyramid depicting the reports required by GAAS, GAS, and Circular A-133 appears in exhibit 3 of chapter 1 of this SOP. Auditors need to understand the intended purpose of each report and should tailor the reports to their specific situations. The standard reports are illustrated in appendix D of this SOP. Modifications to the standard reports for circumstances such as uncertainty are also presented in appendix D. Other situations may arise that will require other modifications to these reports. It is not practicable to anticipate all situations that may be encountered by the auditor. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

Reports Required by *Government Auditing Standards*

7.2. The following reports should be issued in an audit performed in accordance with *Government Auditing Standards:*

- A report on the organization's basic financial statements
- A report on internal control structure policies and procedures based solely on an understanding of the internal control structure and an assessment of control risk obtained as a part of the audit of the basic financial statements
- A report on compliance with laws and regulations that may have a direct and material effect on the basic financial statements

The Auditor's Report on the Basic Financial Statements

7.3. Financial reporting under *Government Auditing Standards* includes an organization's basic financial statements and the auditor's report on the basic financial statements as required by generally accepted auditing standards.

7.4. Circular A-133 requires the auditor to express an opinion about whether the basic financial statements of an NPO as a whole are presented fairly in conformity with GAAP.[27] The financial statements provide the appropriate funding agency with an understanding of an entity's accounting policies and procedures. When assessing whether the basic financial statements are presented fairly in conformity with GAAP, the auditor should consider whether noncompliance with any federal, state, or local laws would materially affect the statements. Although chapter 5, paragraph 3, of *Government Auditing Standards* states that, for NPO financial audits, a statement should be included in the auditor's report that the audit was made in

[27] If an organization prepares its basic financial statements in conformity with a comprehensive basis of accounting other than GAAP, the cognizant audit agency may be contacted to ascertain whether these financial statements will meet the Circular A-133 audit requirement. Reporting guidance for financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP is presented in SAS No. 62.

accordance with generally accepted government auditing standards, and although the PCIE checklists include a question on whether the report includes such a statement, federal reviewers have accepted reports on the financial statements, but not other reports, that do not refer to *Government Auditing Standards*. The auditor is permitted to refer to both GAAS and *Government Auditing Standards* in the auditor's report in the situations illustrated in exhibit D-1 herein, as follows: ". . . we conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. . . ."

The Auditor's Report on the Internal Control Structure

7.5. Both *Government Auditing Standards* and SAS No. 60 require the communication of reportable conditions noted in an audit. However, *Government Auditing Standards* differs from GAAS in that GAS requires a *written* report on the internal control structure in all audits, regardless of whether reportable conditions are noted. To issue this report on the internal control structure, the auditor should complete the level of audit work required by SAS No. 55. It should be noted that, beyond the issuance of an auditor's report on the internal control structure, GAS requires no more work on the internal control structure than does GAAS. An illustrative report on the internal control structure is presented in exhibit D-3 of appendix D to this SOP.

7.6. The following chart summarizes the differences between SAS No. 60 and GAS.

**GAS Report on the Internal Control Structure—
How It Differs From SAS No. 60**

	GAS	*SAS No. 60*
When is a report issued?	In every audit	When reportable conditions are noted
What is the form of the report?	Written	Oral or written
Should the auditor identify the internal control structure categories considered?	Yes	No
Should the auditor separately identify those reportable conditions that are significant enough to be material weaknesses?	Yes	Permitted but not required

Identification of Controls

7.7. Depending on the circumstances, classifications or categories of controls identified as part of an organization's internal control structure may include operating cycles, financial statement captions, accounting system applications, or other classifications. *Government Auditing Standards* includes the following categories according to which the internal control structure might be classified in the auditor's report:

- Cycles of the entity's activity
  - Treasury or financing
  - Revenue/receipts
  - Purchases/disbursements
  - External financial reporting

- Financial statement captions
  - — Cash and cash equivalents
  - — Receivables
  - — Inventory
  - — Property and equipment
  - — Payables and accrued liabilities
  - — Debt
  - — Fund balance
- Accounting applications
  - — Billings
  - — Receivables
  - — Cash receipts
  - — Purchasing and receiving
  - — Accounts payable
  - — Cash disbursements
  - — Payroll
  - — Inventory control
  - — Property and equipment
  - — General ledger

7.8. Types of controls vary from entity to entity. Auditors may modify these examples or use other classifications, as appropriate, for the particular circumstances on which they are reporting. Only those controls that are relevant in the circumstances should be listed in the report.

7.9. The auditor's report on internal control structure required by *Government Auditing Standards* is based on the auditor's consideration of the internal control structure as required by SAS No. 55. The report does not express an opinion on the NPO's internal control structure, but rather describes the extent of work performed as required by SAS No. 55. The report includes the requirements of SAS No. 60 as well as the additional requirements of *Government Auditing Standards.* These additional requirements include the identification of significant internal control structure categories and a description of the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk. Page 5-6 of *Government Auditing Standards* notes that these controls include the internal control structure policies and procedures established to ensure compliance with laws and regulations that could have a direct and material effect on the financial statements. When federal awards are material to the NPO's financial statements, the control categories identified include the controls over the general and specific compliance requirements relative to federal awards programs. *Government Auditing Standards* also states that the report should include a description of reportable conditions as well as separately identify those reportable conditions that are considered material weaknesses. An example of standard reporting language is presented in exhibit D-3 of appendix D of this SOP, and a modification when there are no material weaknesses and no reportable conditions is shown in note 3 to exhibit D-3 in appendix D of this SOP.

Identification of Reportable Conditions

7.10. Reportable conditions are defined in SAS No. 60 as "significant deficiencies in the design or operation of the internal control structure that could adversely affect the entity's ability to record, process, summarize, and report financial data in the financial statements." Although *Government*

Auditing Standards, like SAS No. 60, does not require the auditor to search for reportable conditions, the auditor should be aware, during the course of the audit, that such deficiencies may exist.

7.11. Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. Note 3 to exhibit D-3 of appendix D to this SOP illustrates a report that an auditor may issue to satisfy the requirements of *Government Auditing Standards* if no reportable conditions are noted during an audit.

Nonreportable Conditions

7.12. If an auditor issues a separate written communication describing "nonreportable conditions," as discussed in paragraphs 38 and 39 of SAS No. 68, the auditor's report on the internal control structure should refer to that separate communication in order to comply with *Government Auditing Standards.* An example of such a reference is included in Note 3 to exhibit D-3 of appendix D to this SOP.

The Auditor's Report on Compliance With Laws and Regulations

7.13. *Government Auditing Standards* requires auditors to report on compliance with laws and regulations that, if violated, could have a direct and material effect on an entity's financial statements. The report encompasses federal, state, and local laws and regulations that, if violated, could materially affect the basic financial statements, and expresses positive assurance on items tested and found to be in compliance with applicable laws and regulations and negative assurance on items not tested. The auditor will have complied with the requirements of *Government Auditing Standards* by designing the audit to provide reasonable assurance of detecting errors, irregularities, and illegal acts resulting from violations of laws and regulations that have a direct effect on the determination of financial statement amounts that are material to the financial statements, as required by SAS No. 53 and SAS No. 54. An illustrative report on compliance with laws and regulations is presented in exhibit D-4 of appendix D to this SOP.

7.14. Positive assurance is expressed as a statement by the auditor that the tested items were in compliance with applicable laws and regulations. Negative assurance is expressed as a statement that nothing came to the auditor's attention in the course of performing specified procedures that caused him or her to believe that the untested items were not in compliance with applicable laws and regulations.

7.15. The auditor may need to modify the statement of negative assurance based on the results of his or her tests of compliance. In the event that instances of noncompliance are reported as a result of tests performed, the auditor should consider the extent to which the pervasiveness of reported instances of noncompliance may affect the auditor's ability to express negative assurance with respect to items not tested. For example, an auditor may find a systemic miscalculation of amounts due to suppliers who were selected for testing that the auditor believes is material to the financial statements. Because the exception is systemic and has probably affected other untested items, the auditor may not be able to provide negative assurance. If, based on the results of compliance tests performed, the auditor concludes that negative assurance cannot be provided, he or she should so state in the report and include the reason(s) that such assurance cannot be provided.

7.16. Paragraph 7 of page 5-3 of *Government Auditing Standards* requires that the auditor's report on compliance include all material instances of noncompliance related to the organization's financial statements or to the program, award, claim, fund, or group of accounts being audited. Immaterial instances of noncompliance are not required to be included in the compliance report but should be reported to the organization in a separate letter. Paragraph 30 of SAS No. 68 states that if the auditor has issued a separate letter describing immaterial instances of noncompliance, the compliance report should include a reference to that letter.

Illegal Acts

7.17. Illegal acts are violations of laws or government regulations. They may include such matters as falsification of records or reports and misappropriation of funds or other assets. SAS No. 54 discusses the auditor's responsibilities with respect to illegal acts, and paragraphs 31 and 32 of SAS No. 68 and chapter 5 of *Government Auditing Standards* provide additional guidance on the reporting of illegal acts.

7.18. If the auditor is aware of the occurrence of illegal acts and he or she remains uncertain about whether they will materially affect the financial statements, his or her report on the financial statements should be qualified or a disclaimer of opinion should be issued. Both SAS Nos. 53 and 54 discuss situations in which the independent auditor may wish to consult with legal counsel about withdrawing from an engagement.

Reports Required by OMB Circular A-133

7.19. SAS No. 68 and Circular A-133 require the auditor to issue the following reports on an organization's federal awards:

a. Reports required to be issued in an audit performed in accordance with *Government Auditing Standards,* as described in paragraphs 7.2 through 7.16 of this SOP

b. A report on a supplementary schedule of the entity's federal awards

c. A report on the internal control structure policies and procedures used in administering federal awards

d. A report on compliance with specific laws and regulations that may have a direct and material effect on each major program

e. A report on compliance with certain laws and regulations applicable to nonmajor programs

f. A report on compliance with general requirements

The Auditor's Report on the Schedule of Federal Awards

7.20. The recipient or subrecipient of an award is responsible for preparing a schedule of federal awards. Chapter 4 of this SOP describes the presentation requirements governing the schedule. Illustrative reports on the schedule of federal awards are presented in exhibits D-1 and D-2 of appendix D to this SOP.

Additional Schedules

7.21. Circular A-133 does not require recipients to provide additional schedules such as a schedule of indirect costs. Although not required, the recipient may include any additional information that will make the reports more useful to the federal agencies. For example, a federal agency may need a schedule of indirect costs in lieu of performing a separate audit. In this case, it may be mutually beneficial for the NPO to include the schedule as part of the report.

The Auditor's Report on the Internal Control Structure Used in Administering Federal Awards

7.22. Circular A-133 expands on *Government Auditing Standards* and requires that the auditor determine and report whether an NPO has an internal control structure to provide reasonable assurance that it is managing its federal awards in compliance with applicable laws and regulations. The auditor's report should include—

- If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements.
- A description of the scope of work performed to obtain an understanding of the internal control structure, to assess control risk, and to test the internal control structure policies and procedures.
- A description of the NPO's significant control policies and procedures established to provide reasonable assurance that it is managing its federal awards in compliance with applicable laws and regulations.
- Any reportable conditions noted, including the identification of material weaknesses.

It should be noted that these requirements exceed the minimum requirement of SAS No. 55 to understand the internal control structure and assess control risk in that they require the auditor to test the internal control structure policies and procedures related to federal awards. An illustrative report on the internal control structure used in administering federal awards is presented in exhibit D-8 of appendix D to this SOP.

7.23. Circular A-133 states that "tests of controls will not be required for those areas where internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance. . . ." Such a situation is a reportable condition. In addition, Circular A-133 states that if the auditor limits his or her consideration of the internal control structure for any reason, the circumstances should be disclosed in the auditor's report on the internal control structure.

The Auditor's Report on Compliance With Laws and Regulations Related to Major Programs

7.24. *Uncertainties and Scope Limitations.* Testing an entity's compliance with general and specific compliance requirements demands that auditors make a comply/noncomply decision about an entity's adherence to those laws and regulations. Circular A-133 requires the auditor to express an opinion about whether the NPO has complied with laws and regulations that may have a direct and material effect on each of its major programs. To comply with this requirement, the auditor should provide an opinion about whether each major program is in compliance, in all material respects, with the specific requirements identified in the report. The report makes reference to any immaterial instances of noncompliance with specific requirements that are included in the schedule of findings and questioned costs or in a separate communication to the management of the NPO. If there are no such immaterial instances of noncompliance, the auditor may so note in the report. If a comply/noncomply decision cannot be made because the auditor is prevented from performing sufficient procedures by the client or by other circumstances, a scope limitation, not an uncertainty, would exist. When an instance of noncompliance has occurred but the resolution of the noncompliance is not known, an uncertainty would exist. The following situations could occur when the auditor is reporting on the results of compliance testing:

- If appropriate evidence cannot be examined to support the comply/noncomply decision, a scope limitation would exist and the audit report would need to be modified. (For illustrations of such reports, see exhibit D-10 in appendix D to this SOP.) However, if the auditor concludes that compliance with a requirement cannot be reasonably estimated or measured, the auditor would be precluded from issuing an opinion on compliance with a specific requirement (see exhibit D-14 in appendix D to this SOP). Further guidance on reporting on compliance with specific requirements for major programs is contained in paragraphs 80 through 86 of SAS No. 68.
- If the auditor examined sufficient evidence to support a noncompliance finding, a modification to the auditor's report on compliance should be considered in light of several factors, including the number and type of instances of noncompliance, determinability of questioned costs, and materiality of questioned costs. If, after considering these factors, the auditor—
  - Believes the instance of noncompliance has a material effect on a federal program, the auditor's report should be modified-qualified or adverse (see exhibits D-11 and D-12 in appendix D to this SOP).
  - Cannot determine whether the instance of noncompliance could have a material effect on the program, an uncertainty exists. Accordingly, the report on compliance should state that noncompliance occurred but that the effect on the federal award program cannot presently be determined. The auditor also should consider the effect of uncertainties associated with federal programs on the basic financial statements and modify that report if necessary. (See exhibit D-14 in appendix D to this SOP.)

Illustrative reports on compliance with laws and regulations related to major programs are presented in appendix D to this SOP as follows:

Exhibit	*Nature of Report*
D-9	Unqualified opinion
D-10	Qualified opinion—scope limitation
D-11	Qualified opinion—noncompliance
D-12	Adverse opinion
D-13	Disclaimer of opinion
D-14	Uncertainties

Reporting on Compliance With General Requirements

7.25. Circular A-133 requires the auditor to issue a report on compliance with general requirements regardless of whether the organization being audited has major programs. SAS No. 68 states that determining the extent of any tests of compliance with the general requirements is a matter of professional judgment. SAS No. 68 does not require the auditor to issue an opinion on compliance with the general requirements; rather, the auditor should issue a report on the results of procedures used to test compliance with the general requirements. SAS No. 68 specifies the basic elements of a report expressing positive and negative assurance on compliance with the general requirements.

As noted in paragraph 7.15, the auditor may need to modify the statement of negative assurance based on the results of his or her tests of compliance. An illustrative report on compliance with the general requirements is presented in exhibit D-15 of appendix D to this SOP.

Reporting Compliance With Specific Requirements Applicable to Nonmajor Program Transactions

7.26. Circular A-133 requires the auditor to issue a report on nonmajor programs that provides "a statement of positive assurance on those items that were tested for compliance and negative assurance on those items not tested." The auditor may have selected transactions from nonmajor programs for testing in connection with the audit of the financial statements or the consideration of the internal control structure. As noted in chapter 6, if the auditor has selected such transactions, they should be tested for compliance with the specific requirements that apply to the individual transactions. The auditor need not test for compliance with the general requirements or the specific requirements that apply to the program as a whole, such as matching and reporting requirements. If the auditor has not selected any nonmajor program transactions, or if the entity has no nonmajor programs, no report is required. An illustrative report on compliance with nonmajor program requirements is presented in exhibit D-18 of appendix D to this SOP.

Dating of Reports

7.27. Since the report on the Schedule of Federal Awards indicates that the auditor is reporting "in relation to" the basic financial statements, it should carry the same date as the report on these statements. Furthermore, since the reports on compliance and internal control structure, as required by *Government Auditing Standards,* relate to the basic financial statements and are based on GAAS audit procedures performed, they should also be dated the same date as the report on the basic financial statements.

7.28. Ideally, the reports required by OMB Circular A-133 should also be dated the same as the other reports, but they often carry a later date because some of the audit work to satisfy the Circular A-133 audit requirements may be done subsequent to the work on the basic financial statements. In any case, when issuing the report on the basic financial statements, the auditor should consider the effect of any material contingent liabilities resulting from possible noncompliance in accordance with FASB Statement No. 5. If, after issuing the report on the basic financial statements, the auditor discovers instances of noncompliance that materially affect the statements, he or she should follow the guidance in SAS No. 1, sections 560 and 561.

Combined Reporting

7.29. The reports issued to comply with the reporting requirements of Circular A-133 involve varying levels of materiality and different forms of reporting. Although it may be feasible in some circumstances to combine certain of the reports, it is very difficult to combine them without making them very long and confusing. In addition, the PCIE Desk Review Checklist is designed to review each of the seven individual reports. Accordingly, auditors are strongly discouraged from issuing combined reports.

Schedule of Findings and Questioned Costs

7.30. Circular A-133 requires that the auditor's report on compliance include a summary of material findings of noncompliance and an identification of total amounts questioned as a result of noncompliance, if any, for each federal award and the corrective action recommended by the auditor. Immaterial findings may be included in a schedule of findings and questioned costs or in a separate communication to the management of the NPO.

7.31. According to Circular A-133 and *Government Auditing Standards*, in reporting material instances of noncompliance, auditors should "place their findings in proper perspective." This perspective is both quantitative and qualitative. The extent of material noncompliance should be considered in relation to the number and dollar amount of transactions tested, the size of the population in terms of number of items and dollars, its likely impact on questioned costs, and the dollar amount questioned in order to give the reader a context within which to judge the extent of noncompliance. The auditor's report on compliance should include a summary of all material instances (findings) of noncompliance and identify total amounts questioned, if any, for each federal award. A table may be an appropriate method of summarizing extensive findings.

7.32. In presenting the findings, the auditor should refer to the guidance on report contents and report presentation in paragraphs 9 through 69 of chapter 7 of *Government Auditing Standards*, although these relate specifically to performance rather than financial audits. That guidance suggests that well-developed findings are those that provide sufficient information to federal, state and local officials to permit timely and corrective action. Findings generally consist of statements of the conditions (what is), criteria (what should be), effect (the difference between what is and what should be), and cause (why it happened). PCIE Position Statement No. 6, Question 41, states that the following specific information should be included in findings:

- The award name, award number, grantor, CFDA number, and grant year;
- The condition found, including facts relied on that indicate that noncompliance occurred;
- Specific requirement for which noncompliance is found, including regulatory, statutory, or other citation;
- Identification of the questioned costs and how they were computed;
- The cause of the noncompliance;
- Recommendation for corrective action to prevent future occurrences of noncompliance;
- Pertinent views of responsible officials of the audited entity concerning the finding and what corrective action is planned; and
- Other information necessary to determine the cause and effect in order to take proper corrective action.

Views of Responsible Officials (Organization's Comments)

7.33. The subsection entitled "Views of Responsible Officials" on page 7-10 of *Government Auditing Standards* states:

> The report should include the pertinent views of responsible officials of the organization, program, activity, or function audited concerning the auditor's findings, conclusions, and recommendations, and what corrective action is planned.

Normally, these views would be presented in the recipient's comments on the auditor's findings and recommendations in accordance with paragraph 15(g) of Circular A-133.

7.34. The comments should include a statement by responsible officials of the audited organization concerning their agreement with the findings, conclusions, and recommendations reported. If the organization disagrees with the findings, conclusions, and recommendations and the auditor concludes that they are valid, a rebuttal to the organization's comments addressing the reasons why the auditor has not changed the findings, conclusions, and recommendations should be included in the schedule of findings and questioned costs. The presentation of views is separate from the organization's corrective action plan, which it submits directly to the sponsor or cognizant agency.

Audit Resolution

7.35. The first step in resolving audit findings is for the organization to respond to the auditor's findings and recommendations. The response will normally be in the form of a written corrective action plan and should include who will take what corrective action by what date. The organization should indicate and provide reasons when it does not agree with the auditor's findings or does not think corrective action is necessary. The corrective action plan should be submitted with the audit report, which is due within thirty days after completion of the audit.

7.36. As noted in PCIE Position Statement No. 6, Question 45, the federal agencies responsible for audit resolution will evaluate the auditor's findings and recommendations along with the NPO's corrective action plan. Each federal agency responsible for audit resolution is required to issue a management decision within six months of receipt of the audit report. The management decision is the federal agency's response to the auditor's findings and the NPO's corrective action plan. A management decision can include additional actions necessary to resolve the findings.

7.37. Resolution normally occurs when the federal agency responds with a management decision. Upon learning of the finding, the NPO should proceed with corrective action as rapidly as possible.

7.38. Resolution of findings that relate to the programs of a single federal agency is the responsibility of that agency. Resolution of findings affecting programs of more than one federal agency is coordinated by the cognizant agency. A prime recipient is required to ensure that appropriate corrective action is taken by a subrecipient.

7.39. Sanctions such as disallowed costs, or withholding or suspending awards, are available to federal agencies when proper corrective action on audit findings is not made in a timely manner.

7.40. Findings may also serve as a basis for a federal agency's conducting or contracting for additional audit work. Appendix F of this SOP includes illustrations of the reporting of noncompliance.

Audit Follow-Up (Status of Prior Audit Findings)

7.41. Section 2.i of Attachment F to Circular A-110 provides that an organization have a systematic method to assure timely and appropriate resolution of audit findings and recommendations. Paragraphs 3.47 and 3.48 of this SOP describe the requirement for audit follow-up in *Government Auditing Standards.*

7.42. Federal agencies are required to track the status of management's actions on significant or material findings and recommendations from prior audits.

7.43. The management of some NPOs advocate routine disclosure of the status of separate grantor audits of grant or entitlement programs. Such disclosure is not necessary in the absence of uncertainties related to claims for refunds asserted in connection with such third-party audits. The auditor should consider the effect of aggregated identified noncompliance on the financial statements when preparing his or her report. FASB Statement No. 5 provides guidance in accounting for and reporting on such matters.

7.44. Some events of noncompliance do not have material financial implications on the financial statements, and disclosure of them, therefore, is not required. Nevertheless, special consideration should be given to those events for purposes of reporting to sponsors or donors and other purposes.

Submission of Reports

7.45. Circular A-133 requires that copies of the audit reports be submitted in accordance with *Government Auditing Standards.* GAS requires that the audit reports be submitted to the organization being audited and to the appropriate officials of the organizations requiring or arranging for the audits (including external funding organizations) thirty days after the completion of the audit, unless legal restrictions, ethical considerations, or other arrangements prevent such distribution. Subrecipients should submit copies of the audit reports to recipients that provided federal awards.

7.46. The reports are due within thirty days after the completion of the audit, but the audit should be completed and the report submitted no later than thirteen months after the end of the recipient's fiscal year, unless the cognizant or oversight agency agrees to a longer period.

7.47. The NPO is responsible for submitting *all* reports to each federal agency that provides direct federal funds. Also, subrecipients must distribute copies of reports to all recipients that provide them with federal funds. The report distribution requirements are met when the report is distributed by either the NPO or its auditor. PCIE Position Statement No. 6 includes a schedule of federal agency contact points for Circular A-133 audits.

7.48. The NPO should include with the report a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings.

7.49. Both recipients and subrecipients receiving federal awards over $100,000 are required to send a copy of the report to the central clearinghouse designated by the Office of Management and Budget. The address is:

Federal Audit Clearinghouse
Bureau of the Census
1201 E. 10th Street
Jeffersonville, IN 47132

7.50. While the various auditor's reports may have different dates and may be received by the NPO at different times, they should be delivered together to the cognizant or other oversight agency.

Program Audit Reporting

7.51. As noted in PCIE Position Statement No. 6, Question 22, in many cases a program-specific audit guide will be available to provide specific guidance on compliance testing, audit procedures, and reporting. The auditor should determine the availability of agency-prepared supplements or audit guides. This can be done by reviewing the *Program Audit Guide Survey* (October 1991) prepared by the PCIE Standards Subcommittee. The survey (order number PCIE-06-064) may be obtained by written request to the

Treasury Office of Inspector General, Room 7210, ICC Building, 1201 Constitution Ave., N.W., Washington, DC 20220 or by FAX to (202) 927-5418.

7.52. The auditor may also contact the appropriate Inspector General's Office to determine whether subsequent audit guides have been issued or to obtain a copy of an audit guide. When a current program-specific audit guide is not available, the auditor may obtain guidance from the program laws and regulations, grant agreements, and the Compliance Supplements.

7.53. Program-specific audits for which no current federal agency audit guide is available must conform to the reporting required by *Government Auditing Standards*. The reporting should normally include an opinion on the financial statements of the program, a report on the program's internal controls, and a report on program compliance with laws and regulations. A schedule of findings and questioned costs, management letter, or report on illegal acts may also be required when applicable.

7.54. A program audit may usually be performed on either the NPO fiscal year or the award year. However, for first-time audits or changes to existing audit periods, the auditor should contact the grantor agency or review the program audit guide, laws, and regulations concerning the proper audit period.

Stub Periods

7.55. Stub periods may occur when converting from one type of audit to another or when changing audit periods. Arrangements should be made to meet audit requirements for federal expenditures during the stub period. This is usually done either as a separate audit of the stub period or by including federal expenditures during the stub period with the Circular A-133 audit. The cognizant, oversight, or grantor agency should be contacted for advice on audit procedures for stub periods.

Freedom of Information Act

7.56. In accordance with the principles of the Freedom of Information Act (Title 5 of U.S. Code Section 552), audit agency and nonfederal reports issued to grantees and contractors are available, if they are requested, to members of the press and the general public, to the extent that information contained in them is not subject to exemptions of the Act that the cognizant agency chooses to exercise. Accordingly, the auditor should not include names, social security numbers, other personal identification, or other potentially sensitive matters in either the body of the report or any attached schedules.

APPENDIX A

OMB Circular A-133

SUBJECT: Audits of Institutions of Higher Education and Other Nonprofit Organizations

1. *Purpose.* Circular A-133 establishes audit requirements and defines Federal responsibilities for implementing and monitoring such requirements for institutions of higher education and other nonprofit institutions receiving Federal awards.

2. *Authority.* Circular A-133 is issued under the authority of the Budget and Accounting Act of 1921, as amended; the Budget and Accounting Procedures Act of 1950, as amended; Reorganization Plan No. 2 of 1970; and Executive Order No. 11541.

3. *Supersession.* Circular A-133 supersedes Attachment F, subparagraph 2h, of Circular A-110, "Uniform Administrative Requirements for Grants and other Agreements with Institutions of Higher Education, Hospitals, and other Nonprofit Organizations."

4. *Applicability.* The provisions of Circular A-133 apply to:

a. Federal departments and agencies responsible for administering programs that involve grants, cost-type contracts and other agreements with institutions of higher education and other nonprofit recipients.

b. Nonprofit institutions, whether they are recipients, receiving awards directly from Federal agencies, or are sub-recipients, receiving awards indirectly through other recipients.

These principles, to the extent permitted by law, constitute guidance to be applied by agencies consistent with and within the discretion, conferred by the statutes governing agency action.

5. *Requirements and Responsibilities.* The specific requirements and responsibilities of Federal departments and agencies and institutions of higher education and other nonprofit institutions are set forth in the attachment.

6. *Effective Date.* The provisions of Circular A-133 are effective upon publication and shall apply to audits of nonprofit institutions for fiscal years that begin on or after January 1, 1990. Earlier implementation is encouraged. However, until this Circular is implemented, the audit provisions of Attachment F to Circular A-110 shall continue to be observed.

7. *Policy Review (Sunset) Date.* Circular A-133 will have a policy review three years from the date of issuance.

8. *Inquiries.* Further information concerning Circular A-133 may be obtained by contacting the Financial Management Division, Office of Management and Budget, Washington, D.C. 20503, telephone (202) 395-3993.

Richard G. Darman
Director

ATTACHMENT

1. ***Definitions.*** For the purposes of this Circular, the following definitions apply:

a. "Award" means financial assistance, and Federal cost-type contracts used to buy services or goods for the use of the Federal Government. It includes awards received directly from the Federal agencies or indirectly through recipients. It does not include procurement contracts to vendors under grants or contracts, used to buy goods or services. Audits of such vendors shall be covered by the terms and conditions of the contract.

b. "Cognizant agency" means the Federal agency assigned by the Office of Management and Budget to carry out the responsibilities described in paragraph 3 of this Attachment.

c. "Coordinated audit approach" means an audit wherein the independent auditor, and other Federal and non-federal auditors consider each other's work, in determining the nature, timing, and extent of his or her own auditing procedures. A coordinated audit must be conducted in accordance with *Government Auditing Standards* and meet the objectives and reporting requirements set forth in paragraph 12(b) and 15, respectively, of this Attachment. The objective of the coordinated audit approach is to minimize duplication of audit effort, but not to limit the scope of the audit work so as to preclude the independent auditor from meeting the objectives set forth in paragraph 12(b) or issuing the reports required in paragraph 15 in a timely manner.

d. "Federal agency" has the same meaning as the term 'agency' in Section 551(1) of Title 5, United States Code.

e. "Federal Financial Assistance."

(1) "Federal financial assistance" means assistance provided by a Federal agency to a recipient or subrecipient to carry out a program. Such assistance may be in the form of:

— grants;
— contracts;
— cooperative agreements;
— loans;
— loan guarantees;
— property;
— interest subsidies;
— insurance;
— direct appropriations;
— other non-cash assistance.

(2) Such assistance does not include direct Federal cash assistance to individuals.

(3) Such assistance includes awards received directly from Federal agencies, or indirectly when sub-recipients receive funds identified as Federal funds by recipients.

(4) The granting agency is responsible for identifying the source of funds awarded to recipients; the recipient is responsible for identifying the source of funds awarded to sub-recipients.

f. "Generally accepted accounting principles" has the meaning specified in the *Government Auditing Standards.*

g. "Independent auditor" means:

(1) A Federal, State, or local government auditor who meets the standards specified in the *Government Auditing Standards;* or

(2) A public accountant who meets such standards.

h. "Internal control structure" means the policies and procedures established to provide reasonable assurance that:

(1) Resource use is consistent with laws, regulations, and award terms;

(2) Resources are safeguarded against waste, loss, and misuse; and

(3) Reliable data are obtained, maintained, and fairly disclosed in reports.

i. "Major program" means an individual award or a number of awards in a category of Federal assistance or support for which total expenditures are the larger of three percent of total Federal funds expended or $100,000, on which the auditor will be required to express an opinion as to whether the major program is being administered in compliance with laws and regulations.

Each of the following categories of Federal awards shall constitute a major program where total expenditures are the larger of three percent of total Federal funds expended or $100,000:

— Research and Development.

— Student Financial Assistance.

— Individual awards not in the student aid or research and development category.

j. "Management decision" means the evaluation by the management of an establishment of the findings and recommendations included in an audit report and the issuance of a final decision by management concerning its response to such findings and recommendations, including actions concluded to be necessary.

k. "Nonprofit institution" means any corporation, trust, association, cooperative or other organization which (1) is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest; (2) is not organized primarily for profit; and (3) uses its net proceeds to maintain, improve, and/or expand its operations. The term "nonprofit institutions" includes institutions of higher education, except those institutions that are audited as part of single audits in accordance with Circular A-128 "Audits of State and Local Governments." The term does not include hospitals which are not affiliated with an institution of higher education, or State and local governments and Indian tribes covered by Circular A-128 "Audits of State and Local Governments."

l. "Oversight" agency means the Federal agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency, unless no direct funding is received. Where there is no direct funding, the Federal agency with the predominant indirect funding will assume the general oversight responsibilities.

The duties of the oversight agency are described in paragraph 4 of this Attachment.

m. "Recipient" means an organization receiving financial assistance to carry out a program directly from Federal agencies.

n. "Research and development" includes all research activities, both basic and applied, and all development activities that are supported at universities, colleges, and other nonprofit institutions. "Research" is defined as a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. "Development" is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes.

o. "Student Financial Assistance" includes those programs of general student assistance in which institutions participate, such as those authorized by Title IV of the Higher Education Act of 1965 which is administered by the U.S. Department of Education and similar programs provided by other Federal agencies. It does not include programs which provide fellowships of similar awards to students on a competitive basis, or for specified studies or research.

p. "Sub-recipient" means any person or government department, agency, establishment, or nonprofit organization that receives financial assistance to carry out a program through a primary recipient or other sub-recipient, but does not include an individual that is a beneficiary of such a program. A sub-recipient may also be a direct recipient of Federal awards under other agreements.

q. "Vendor" means an organization providing a recipient or sub-recipient with generally required goods or services that are related to the administrative support of the Federal assistance program.

2. ***Audit of Nonprofit Institutions.***

a. *Requirements Based on Awards Received.*

(1) Nonprofit institutions that receive $100,000 or more a year in Federal awards shall have an audit made in accordance with the provisions of this Circular. However, nonprofit institutions receiving $100,000 or more but receiving awards under only one program have the option of having an audit of their institution prepared in accordance with the provisions of the Circular or having an audit made of the one program. For prior or subsequent years, when an institution has only loan guarantees or outstanding loans that were made previously, the institution may be required to conduct audits for those programs, in accordance with regulations of the Federal agencies providing those guarantees or loans.

(2) Nonprofit institutions that receive at least $25,000 but less than $100,000 a year in Federal awards shall have an audit made in accordance with this Circular or have an audit made of each Federal award, in accordance with Federal laws and regulations governing the programs in which they participate.

(3) Nonprofit institutions receiving less than $25,000 a year in Federal awards are exempt from Federal audit requirements, but records must be available for review by appropriate officials of the Federal grantor agency or subgranting entity.

b. *Oversight by Federal Agencies.*

(1) To each of the larger nonprofit institutions the Office of Management and Budget (OMB) will assign a Federal agency as the cognizant agency for monitoring audits and ensuring the resolution of audit findings that affect the programs of more than one agency.

(2) Smaller institutions not assigned a cognizant agency will be under the general oversight of the Federal agency that provides them with the most funds.

(3) Assignments to Federal cognizant agencies for carrying out responsibilities in this section are set forth in a separate supplement to this Circular.

(4) Federal Government-owned, contractor-operated facilities at institutions or laboratories operated primarily for the Government are not included in the cognizance assignments. These will remain the responsibility of the contracting agencies. The listed assignments cover all of the functions in this Circular unless otherwise indicated. The Office of Management and Budget will coordinate changes in agency assignments.

3. ***Cognizant Agency Responsibilities.*** A cognizant agency shall:

a. Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of this Circular.

b. Provide technical advice and liaison to institutions and independent auditors.

c. Obtain or make quality control reviews of selected audits made by non-Federal audit organizations, and provide the results, when appropriate, to other interested organizations.

d. Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any reported illegal acts or irregularities. A cognizant agency should also inform State or local law enforcement and prosecuting authorities, if not advised by the recipient, of any violation of law within their jurisdiction.

e. Advise the recipient of audits that have been found not to have met the requirements set forth in this Circular. In such instances, the recipient will work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency shall notify the recipient and Federal awarding agencies of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance of independent auditors shall be referred to appropriate professional bodies for disciplinary action.

f. Coordinate, to the extent practicable, audits or reviews made for Federal agencies that are in addition to the audits made pursuant to this Circular, so that the additional audits or reviews build upon audits performed in accordance with the Circular.

g. Ensure the resolution of audit findings that affect the programs of more than one agency.

h. Seek the views of other interested agencies before completing a coordinated program.

i. Help coordinate the audit work and reporting responsibilities among independent public accountants, State auditors, and both resident and non-resident Federal auditors to achieve the most cost-effective audit.

4. ***Oversight Agency Responsibilities.*** An oversight agency shall provide technical advice and counsel to institutions and independent auditors when requested by the recipient. The oversight agency may assume all or some of the responsibilities normally performed by a cognizant agency.

5. ***Recipient Responsibilities.*** A recipient that receives a Federal award and provides $25,000 or more of it during its fiscal year to a sub-recipient shall:

a. Ensure that the nonprofit institution sub-recipients that receive $25,000 or more have met the audit requirements of this Circular, and that sub-recipients subject to OMB Circular A-128 have met the audit requirements of that Circular;

b. Ensure that appropriate corrective action is taken within six months after receipt of the sub-recipient audit report in instances of non-compliance with Federal laws and regulations;

c. Consider whether sub-recipient audits necessitate adjustment of the recipient's own records; and

d. Require each sub-recipient to permit independent auditors to have access to the records and financial statements as necessary for the recipient to comply with this Circular.

6. ***Relation to Other Audit Requirements.***

a. An audit made in accordance with this Circular shall be in lieu of any financial audit required under individual Federal awards. To the extent that an audit made in accordance with this Circular provides Federal agencies with the information and assurances they need to carry out their overall responsibilities, they shall rely upon and use such information. However, a Federal agency shall make any additional audits or reviews necessary to carry out responsibilities under Federal law and regulation. Any additional Federal audits or reviews shall be planned and carried out in such a way as to build upon work performed by the independent auditor.

b. Audit planning by Federal audit agencies should consider the extent to which reliance can be placed upon work performed by other auditors. Such auditors include State, local, Federal, and other independent auditors, and a recipient's internal auditors. Reliance placed upon the work of other auditors should be documented and in accordance with *Government Auditing Standards.*

c. The provisions of this Circular do not limit the authority of Federal agencies to make or contract for audits and evaluations of Federal awards, nor do they limit the authority of any Federal agency Inspector General or other Federal official.

d. The provisions of this Circular do not authorize any institution or sub-recipient thereof to constrain Federal agencies, in any manner, from carrying out additional audits, evaluations or reviews.

e. A Federal agency that makes or contracts for audits, in addition to the audits made by recipients pursuant to this Circular, shall, consistent with other applicable laws and regulations, arrange for funding the cost of such additional audits. Such additional audits or reviews include financial, performance audits and program evaluations.

7. ***Frequency of Audit.*** Audits shall usually be performed annually but not less frequently than every two years.

8. ***Sanctions.*** No audit costs may be charged to Federal awards when audits required by this Circular have not been made or have been made but not in accordance with this Circular. In cases of continued inability or unwillingness to have a proper audit in accordance with the Circular, Federal agencies must consider appropriate sanctions including:

— withholding a percentage of awards until the audit is completed satisfactorily;

— withholding or disallowing overhead costs; or

— suspending Federal awards until the audit is made.

9. ***Audit Costs.*** The cost of audits made in accordance with the provisions of this Circular are allowable charges to Federal awards. The charges may be considered a direct cost or an allocated indirect cost, determined in accordance with the provisions of Circular A-21, "Cost Principles for Universities" or Circular A-122, "Cost Principles for Nonprofit Organizations," FAR Subpart 31, or other applicable cost principles or regulations.

10. ***Auditor Selection.*** In arranging for audit services institutions shall follow the procurement standards prescribed by Circular A-110, "Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and other Nonprofit Organizations."

11. ***Small and Minority Audit Firms.***

a. Small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals shall have the maximum practicable opportunity to participate in contracts awarded to fulfill the requirements of this Circular.

b. Recipients of Federal awards shall take the following steps to further this goal:

(1) Ensure that small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals are used to the fullest extent practicable;

(2) Make information on forthcoming opportunities available and arrange timeframes for the audit to encourage and facilitate participation by small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals;

(3) Consider in the contract process whether firms competing for larger audits intend to subcontract with small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals;

(4) Encourage contracting with small audit firms or audit firms owned and controlled by socially and economically disadvantaged individuals which have traditionally audited government programs, and in cases where this is not possible, assure that these firms are given consideration for audit subcontracting opportunities;

(5) Encourage contracting with consortiums of small audit firms as described in section (1), above, when a contract is too large for an individual small audit firm or audit firm owned and controlled by socially and economically disadvantaged individuals; and

(6) Use the services and assistance, as appropriate, of such organizations as the Small Business Administration in the solicitation and utilization of small audit firms or audit firms owned and controlled by socially and economically disadvantaged individuals.

12. ***Scope of Audit and Audit Objectives.***

a. The audit shall be made by an independent auditor in accordance with *Government Auditing Standards* developed by the Comptroller General of the United States covering financial audits. An audit under this Circular should be an organization-wide audit of the institution. However, there may be instances where Federal auditors are performing audits or are planning to perform audits at nonprofit institutions. In these cases, to minimize duplication of audit work, a coordinated audit approach may be agreed upon between the independent auditor, the recipient and the cognizant agency or the oversight agency. Those auditors who assume responsibility for any or all of the reports called for by paragraph 15 should follow guidance set forth in *Government Auditing Standards* in using work performed by others.

b. The auditor shall determine whether:

(1) The financial statements of the institution present fairly its financial position and the results of its operations in accordance with generally accepted accounting principles;

(2) The institution has an internal control structure to provide reasonable assurance that the institution is managing Federal awards in compliance with applicable laws and regulations, and controls that ensure compliance with the laws and regulations that could have a material impact on the financial statements; and

(3) The institution has complied with laws and regulations that may have a direct and material effect on its financial statement amounts and on each major Federal program.

13. ***Internal Controls Over Federal Awards; Compliance Reviews.***

a. *General.* The independent auditor shall determine and report on whether the recipient has an internal control structure to provide reasonable assurance that it is managing Federal awards in compliance with applicable laws, regulations, and contract terms, and that it safeguards Federal funds. In performing these reviews, independent auditors should rely upon work performed by a recipient's internal auditors to the maximum extent possible. The extent of such reliance should be based upon the *Government Auditing Standards.*

b. *Internal Control Review.*

(1) In order to provide this assurance on internal controls, the auditor must obtain an understanding of the internal control structure and assess levels of internal control risk. After obtaining an understanding of the controls, the assessment must be made whether or not the auditor intends to place reliance on the internal control structure.

(2) As part of this review, the auditor shall:

(a) Perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance. Tests of controls will not be required for those areas where the internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance, in which case a reportable condition or a material weakness should be reported in accordance with paragraph 15c(2) of this Circular.

(b) Review the recipient's system for monitoring subrecipients and obtaining and acting on sub-recipient audit reports.

(c) Determine whether controls are in effect to ensure direct and indirect costs were computed and billed in accordance with the guidance provided in the general requirements section of the compliance supplement to this Circular.

c. *Compliance Review.*

(1) The auditor shall determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major Federal programs. In addition, transactions selected for nonmajor programs shall be tested for compliance with Federal laws and regulations that apply to such transactions.

(2) In order to determine which major programs are to be tested for compliance, recipients shall identify, in their accounts, all Federal funds received and expended and the programs under which they were received. This shall include funds received directly from Federal agencies, through other state and local governments or other recipients. To assist recipients in identifying Federal awards, Federal agencies and primary recipients shall provide the CFDA numbers to the recipients when making the awards.

(3) The review must include the selection of an adequate number of transactions from each major Federal financial assistance program so that the auditor obtains sufficient evidence to support the opinion on compliance required by paragraph 15c(3) of this

Attachment. The selection and testing of transactions shall be based on the auditors' professional judgment considering such factors as the amount of expenditures for the program; the newness of the program or changes in its conditions; prior experience with the program particularly as revealed in audits and other evaluations (e.g., inspections, program reviews, or system reviews required by FAR); the extent to which the program is carried out through sub-recipients; the extent to which the program contracts for goods or services; the level to which the program is already subject to program reviews or other forms of independent oversight; the adequacy of the controls for ensuring compliance; the expectation of adherence or lack of adherence to the applicable laws and regulations; and the potential impact of adverse findings.

(4) In making the test of transactions, the auditor shall determine whether:

- — the amounts reported as expenditures were for allowable services, and
- — the records show that those who received services or benefits were eligible to receive them.

(5) In addition to transaction testing, the auditor shall determine whether:

- — matching requirements, levels of effort and earmarking limitations were met,
- — Federal financial reports and claims for advances and reimbursement contain information that is supported by books and records from which the basic financial statements have been prepared, and
- — amounts claimed or used for matching were determined in accordance with (1) OMB Circular A-21, "Cost Principles for Educational Institutions"; (2) matching or cost sharing requirements in Circular A-110, "Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Nonprofit Organizations"; (3) Circular A-122, "Cost Principles for Nonprofit Organizations"; (4) FAR subpart 31 cost principles; and (5) other applicable cost principles or regulations.

(6) The principal compliance requirements of the largest Federal programs may be ascertained by referring to the *"Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-profit Institutions,"* and the *"Compliance Supplement for Single Audits of State and Local Governments,"* issued by OMB and available from the Government Printing Office. For those programs not covered in the Compliance Supplements, the auditor should ascertain compliance requirements by reviewing the statutes, regulations, and agreements governing individual programs.

(7) Transactions related to other awards that are selected in connection with examinations of financial statements and evalua-

tions of internal controls shall be tested for compliance with Federal laws and regulations that apply to such transactions.

14. ***Illegal Acts.*** If, during or in connection with the audit of a nonprofit institution, the auditor becomes aware of illegal acts, such acts shall be reported in accordance with the provisions of the *Government Auditing Standards.*

15. ***Audit Reports.***

a. Audit reports must be prepared at the completion of the audit.

b. The audit report shall state that the audit was made in accordance with the provisions of this Circular.

c. The report shall be made up of at least the following three parts:

(1) The financial statements and a schedule of Federal awards and the auditor's report on the statements and the schedule. The schedule of Federal awards should identify major programs and show the total expenditures for each program. Individual major programs other than Research and Development and Student Aid should be listed by catalog number as identified in the *Catalog of Federal Domestic Assistance.* Expenditures for Federal programs other than major programs shall be shown under the caption "other Federal assistance." Also, the value of noncash assistance such as loan guarantees, food commodities or donated surplus properties or the outstanding balance of loans should be disclosed in the schedule.

(2) A written report of the independent auditor's understanding of the internal control structure and the assessment of control risk. The auditor's report should include as a minimum: (1) the scope of the work in obtaining understanding of the internal control structure and in assessing the control risk, (2) the nonprofit institution's significant internal controls or control structure including the controls established to ensure compliance with laws and regulations that have a material impact on the financial statements and those that provide reasonable assurance that Federal awards are being managed in compliance with applicable laws and regulations, and (3) the reportable conditions, including the identification of material weaknesses, identified as a result of the auditor's work in understanding and assessing the control risk. If the auditor limits his/her consideration of the internal control structure for any reason, the circumstances should be disclosed in the report.

(3) The auditor's report on compliance containing:

— An opinion as to whether each major Federal program was being administered in compliance with laws and regulations applicable to the matters described in paragraph 13(c)(3) of this Attachment, including compliance with laws and regulations pertaining to financial reports and claims for advances and reimbursements;

— A statement of positive assurance on those items that were tested for compliance and negative assurance on those items not tested;

— Material findings of noncompliance presented in their proper perspective:
  - The size of the universe in number of items and dollars,
  - The number and dollar amount of transactions tested by the auditors,
  - The number and corresponding dollar amount of instances of noncompliance;

— Where findings are specific to a particular Federal award, an identification of total amounts questioned, if any, for each Federal award, as a result of noncompliance and the auditor's recommendations for necessary corrective action.

d. The three parts of the audit report may be bound into a single document, or presented at the same time as separate documents.

e. Nonmaterial findings need not be disclosed with the compliance report but should be reported in writing to the recipient in a separate communication. The recipient, in turn, should forward the findings to the Federal grantor agencies or subgrantor sources.

f. All fraud or illegal acts or indications of such acts, including all questioned costs found as the result of these acts that auditors become aware of, may be covered in a separate written report submitted in accordance with the *Government Auditing Standards.*

g. The auditor's report should disclose the status of known but uncorrected significant material findings and recommendations from prior audits that affect the current audit objective as specified in the *Government Auditing Standards.*

h. In addition to the audit report, the recipient shall provide a report of its comments on the findings and recommendations in the report, including a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings. If corrective action is not necessary, a statement describing the reason it is not should accompany the audit report.

i. Copies of the audit report shall be submitted in accordance with the reporting standards for financial audits contained in the *Government Auditing Standards.* Sub-recipient auditors shall submit copies to recipients that provided Federal awards. The report shall be due within 30 days after the completion of the audit, but the audit should be completed and the report submitted not later than 13 months after the end of the recipient's fiscal year unless a longer period is agreed to with the cognizant or oversight agency.

j. Recipients of more than $100,000 in Federal awards shall submit one copy of the audit report within 30 days after issuance to a central clearinghouse to be designated by the Office of Management and Budget. The clearinghouse will keep completed audit reports on file.

k. Recipients shall keep audit reports, including subrecipient reports, on file for three years from their issuance.

16. ***Audit Resolution.***

a. As provided in paragraph 3, the cognizant agency shall be responsible for ensuring the resolution of audit findings that affect the programs of more than one Federal agency. Resolution of findings that relate to the programs of a single Federal agency will be the responsibility of the recipient and the agency. Alternate arrangements may be made on case-by-case basis by agreement among the agencies concerned.

b. A management decision shall be made within six months after receipt of the report by the Federal agencies responsible for audit resolution. Corrective action should proceed as rapidly as possible.

17. ***Audit Workpapers and Reports.*** Workpapers and reports shall be retained for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Audit workpapers shall be made available upon request to the cognizant agency or its designee or the General Accounting Office, at the completion of the audit.

APPENDIX B

Reference Documents for Compliance Auditing of Not-for-Profit Organizations

In the planning stage of the audit, independent auditors should become familiar with the applicable documents presented below. The documents are among the most important ones to be used for verification and reference purposes in auditing compliance for NPOs. Sources for these materials are identified below. The auditor should use the most current reference material that applies to the period under audit.

The AICPA publications listed below may be obtained from the American Institute of Certified Public Accountants, Harborside Financial Center, 201 Plaza III, Jersey City, NJ 07311-3881, or by calling 800-862-4272. Federal government publications may be obtained from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402 (order desk telephone: 202-783-3238). Standards of the President's Council on Integrity and Efficiency (except for PCIE Position Statement No. 6) can be obtained by writing or faxing the Treasury Office of Inspector General, Room 7210, ICC Building, 1201 Constitution Avenue, NW, Washington, DC 20220 (fax: 202-927-5418).

Cost Principles

a. OMB Circular A-21, *Cost Principles for Colleges and Universities*

b. OMB Circular A-122, *Cost Principles for Nonprofit Organizations*

c. OASC-3 (45 CFR, Part 74), *Cost Principles for Hospitals*

Auditing Standards

a. AICPA *Professional Standards,* volume 1, including SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*

b. *Government Auditing Standards,* issued by the Comptroller General of the United States (1988 revision)

c. *Guide for Review of Sensitive Payments,* published by the General Accounting Office (GAO)

AICPA Audit Guides and Statements of Position

a. *Audits of Certain Nonprofit Organizations,* which includes SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

b. *Audits of Voluntary Health and Welfare Organizations*

c. *Audits of Colleges and Universities*

d. *Audits of Providers of Health Care Services*

e. *Audit Sampling*

f. *Consideration of the Internal Control Structure in a Financial Statement Audit*

g. *Audits of State and Local Governmental Units*

h. SOP 92-7, *Audits of State and Local Governmental Entities Receiving Federal Financial Assistance*

Office of Management and Budget (OMB) and Other Compliance Guidelines

a. OMB Circular A-21, *Cost Principles for Educational Institutions*

b. OMB Circular A-73, *Audits of Federal Operations and Programs*

c. *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* (October 1991)

d. *Guidelines for Audits of Federal Awards to Nonprofit Organizations,* issued by the Office of Inspector General of the United States Department of Health and Human Services

e. *Compliance Supplement for Single Audits of State and Local Governments* (September 1990)

f. *Catalog of Federal Domestic Assistance*

g. OMB Circular A-88, *Indirect Cost Rates, Audit and Audit Follow-Up at Educational Institutions,* and successive publications (cognizant audit responsibilities)

h. OMB Circular A-110, *Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Nonprofit Organizations*

i. OMB Circular A-122, *Cost Principles for Nonprofit Organizations*

j. OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*

PCIE Statements and Guidance

a. PCIE Statement No. 1 provides guidance on determining when a series of audits of individual federal departments, agencies, and establishments may be considered an audit for purposes of the Single Audit Act.

b. PCIE Statement No. 2 provides guidance to cognizant agencies on determining whether an audit report that does not meet the 50 percent rule on internal control coverage prescribed in the AICPA *Audit and Accounting Guide Audits of State and Local Governmental Units* should be accepted.

c. PCIE Statement No. 3 provides guidance on using a cyclical approach to internal control reviews of nonmajor programs.

d. PCIE Statement No. 4 establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA.

e. PCIE Statement No. 5 provides guidance for certain not-for-profit entities other than institutions of higher education or hospitals not covered by OMB Circular A-110.

f. PCIE Statement No. 6 (order number 041-001-00374-6) answers commonly asked questions about audits of federal programs under OMB Circular A-133. This can be obtained by contacting the Government Printing Office.

g. *Program Audit Guide Survey* was issued by the PCIE Standards Subcommittee (October 1991). One copy can be obtained (order number PCIE-06-064) by writing to the PCIE at:

Department of the Treasury
Office of Inspector General
Room 7210, ICC Bldg.
1201 Constitution Ave., N.W.
Washington, DC 20220

Sponsors' Guidelines

- *Financial Aid Handbook,* issued by the Department of Education
- PHS *Grants Administration Manual* and *Grants Policy Statement*
- The National Science Foundation's *Grants for Scientific Research*
- AID Handbooks
- Federal Acquisition Regulations (FAR)
- Defense Department Supplement (DFARS)
- Standards of Accounting and Financial Reporting for Voluntary Health & Welfare Organizations, third edition (1988), issued by the National Health Council (commonly referred to as the "black book")
- 1988 Combined Federal Campaign Rule 5 CFR Part 950, *Solicitation of Federal Civilian and Uniformed Service Personnel for Contributions to Private Voluntary Organizations,* issued by the United States Office of Personnel Management.

Federal Agency Guidance

Federal Cognizant Agency Audit Organization Guidelines, issued by the President's Council on Integrity and Efficiency (includes desk and quality control review guides, revised May 1991)

Directory of Inspectors General—List of Federal Agency Contact Points for Single Audit Act Questions and Materials

Federal Agency Implementation of Single Audit Requirements

Department of the Interior
Department of Transportation
Department of Agriculture
Department of Commerce
Veterans Administration
Department of Health and Human Services
Department of Labor
Federal Emergency Management Agency
Department of Education
Department of Housing and Urban Development
Department of Energy
Department of Transportation, Federal Highway Administration
Environmental Protection Agency

Quality Standards for Federal Offices of Inspector General, issued by the President's Council on Integrity and Efficiency (Performance Evaluation Committee), January 1986

Common Rule for Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments; Federal Agency Implementation of Common Rule

Guidelines for Audits of Federal Awards to Non-Profit Organizations, issued by the Office of Inspector General, U.S. Department of Health and Human Services

How to Choose an Auditor, issued by Mid-America Intergovernmental Audit Forum

A Guide for Roles and Responsibilities in Subrecipient Audits, issued by Mid-America Intergovernmental Audit Forum

Review Guide for Long-Form University Indirect Cost Proposals, issued by U.S. Department of Health and Human Services.

APPENDIX C

State and Local Audit and Grant Compliance Requirements

In general, there are three types of models under which state governments prescribe audit requirements:

a. *Single Audit*—The state requires the performance of a single audit covering the grants.

b. *Individual Grant Audits*—The state requires that every state grant be audited; individual agencies implement the audit requirements and specify applicable requirements.

c. *Individual Agency Audits*—The state does not have an audit requirement; individual agencies are left to implement their own requirements. Thus, in some cases, audit requirements may not exist for certain grants.

Some cities and other very large municipal units also use similar types of models. In recent years, an increasing number of states and municipalities have adopted a single-audit model to increase audit efficiency.

In determining the most efficient audit approach, the auditor should—

a. Determine the nature of the audit requirements in the state (e.g., ascertain whether the state uses a single-audit model, an individual grant audit model, or an individual agency audit model).

b. Ascertain the relationship of applicable state requirements to any federal audit requirements.

c. Ascertain the nature of funding for the audit costs of such requirements. Typically, the cost of any state requirements that go beyond federal requirements is not covered by federal sponsors.

If the state follows a multiple-agency model and the auditor is engaged to perform and report separately on an individual grant audit on behalf of a state or local agency, he or she should consider the following steps:

- Obtain any applicable audit guidance from the grantor agency.
- Confirm with the grantor agency that any audit guides expected to be used contain all administrative rulings and amendments pertaining to the grant.
- Discuss with the grantor agency the scope of testing that is expected to be performed. The auditor should consider documenting any agreements resulting from such discussions in a proposal, contract, or engagement letter.

APPENDIX D

Illustrative Audit Reports

The following is a list of the reports illustrated in this appendix:

Exhibit D-1

Report on Schedule of Federal Awards[1]

[*Addressee*]

We have audited the financial statements of [*name of organization*] for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[2] These financial statements are the responsibility of [*name of organization*]'s management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Our audit was made for the purpose of forming an opinion on the basic financial statements of [*name of organization*] taken as a whole. The accompanying Schedule of Federal Awards is stated for purposes of additional analysis and is not a required part of the basic financial statements. The information in that Schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly presented in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]
[*Date*]

Notes:

1. This report is intended to be issued when the auditor's report on the basic financial statements is issued separately. However, the auditor may consider combining the report on the basic financial statements with this report (see exhibit D-2).
2. Describe any departure from the standard report.

Exhibit D-2

Report on Basic Financial Statements and Schedule of Federal Awards

[*Addressee*]

We have audited the accompanying balance sheet of [*name of organization*] as of June 30, 19XX, and the related statements of changes in fund balances and [*changes in financial position*] [*cash flows*][1] for the year then ended. These financial statements are the responsibility of [*name of organization*]'s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [*name of organization*] as of June 30, 19XX, and the changes in its fund balances and its [*financial position*] [*cash flows*] for the year then ended, in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the basic financial statements of [*name of organization*] taken as a whole. The accompanying Schedule of Federal Awards for the year ended June 30, 19XX, is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information in that schedule has been subjected to the procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

Note:

1. Statement titles should be revised to conform with the statements presented by the organization.

Exhibit D-3

Report on the Internal Control Structure Based on an Audit of Financial Statements Performed in Accordance With GAS

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *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.

In planning and performing our audit of the financial statements of [*name of organization*] for the year ended June 30, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of [*name of organization*] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories [*identify internal control structure categories*].[2] For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data in a manner that is consistent with the assertions of management in the financial statements.[3]

[Include paragraphs to describe the reportable conditions noted.]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX.[4]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[5]

[*Signature*]
[*Date*]

Notes:

1. Describe any departure from the standard report.
2. See paragraph 7.7 for a discussion of categories to be identified. Also, see paragraphs 6.36 and 6.53 through 6.61 for specific and general requirements, respectively.
3. Paragraph 17 of SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in a Financial Statement Audit,* prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. When the auditor notes no reportable conditions during an audit, he or she may issue a report, such as the following, to satisfy the requirements of *Government Auditing Standards.*

   [The first through the fifth paragraphs of the report are the same as those illustrated above.]

   Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

[*The last two paragraphs of the report are the same as that illustrated above.*]

4. If a separate letter has not been issued, this paragraph should be omitted.
5. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-4

Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of Financial Statements Performed in Accordance With GAS When the Auditor's Procedures Disclose No Material Instances of Noncompliance

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *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.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those provisions.[2]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]
[*Date*]

Notes:

1. Describe any departure from the standard report.
2. If the auditor determines noncompliance is pervasive and he or she is not able to provide negative assurance, the auditor's report should consist of the following:

   [*First three paragraphs as illustrated above.*]

   The results of our tests indicate that, with respect to the items tested, the [*name of organization*] complied with those laws and regulations referred to above, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to items that were not tested by us, there is more than a relatively low risk that the [*name of organization*] may not have complied with the provisions referred to in the preceding paragraph. These matters were considered by us in evaluating whether the basic financial statements are presented fairly in conformity with generally accepted accounting principles.

[*Last paragraph as illustrated above.*]

3. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-5

Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of Financial Statements Performed in Accordance With GAS When Material Instances of Noncompliance Exist

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *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.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in [*name of organization*]'s 19XX financial statements.

[*Include paragraphs describing the material instances of noncompliance noted.*]

We considered these material instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the provisions referred to in the third paragraph of this report; and, with respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those provisions.[2]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]
[*Date*]

Notes:

1. Describe any departure from the standard report.
2. If there is pervasive noncompliance and negative assurance cannot be provided, the report should be modified as shown in exhibit D-4, note 2.
3. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-6

Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of Financial Statements Performed in Accordance With GAS When Uncertainty About the Effects of Noncompliance Exists

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *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.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following instances of noncompliance, the effects of which may be material to the financial statements but for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in [*name of organization*]'s 19XX financial statements.[2]

[*Include paragraphs describing the instances of noncompliance noted.*]

We considered these instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the provisions referred to in the third paragraph of this report; and, with respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those provisions.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]
[*Date*]

Notes:

1. Describe any departure from the standard report.
2. The effect of the instances of noncompliance is considered when reporting on the basic financial statements and, if material to the basic financial statements, an explanatory paragraph similar to the following should be inserted after the opinion paragraph in the auditor's report on the financial statements:

    As discussed in note X, [*name of organization*] failed to comply with certain requirements applicable to the federal awards programs in which it participates. The financial statements do not include an adjustment for any liability that may result from the actions of the organization and federal agencies relative to these instances of noncompliance.

    Auditors should be aware that instances of noncompliance may be material, either individually or in the aggregate, warranting an adverse opinion on the financial statements.
3. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-7

Report on Compliance With Laws, Regulations, Contracts, and Grants Based on an Audit of Financial Statements Performed in Accordance With GAS When the Auditor Decides Not to Perform Any Tests of Compliance[1]

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[2]

We conducted our audit in accordance with generally accepted auditing standards and *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.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of [*name of organization*]'s compliance with such provisions of laws, regulations, contracts, and grants.

However, in connection with our audit, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with the laws, regulations, contracts, and grants referred to in the preceding paragraph.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]
[*Date*]

Notes:

1. This report is only appropriate in rare circumstances, based on assessments of materiality and audit risk, where the auditor may decide not to perform any tests of compliance with provisions of laws, regulations, contracts, and grants. (See paragraph *7.27* of this SOP for discussion of dating of reports.)
2. Describe any departure from the standard report.
3. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-8

Report on the Internal Control Structure Used in Administering Federal Awards

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1] We have also audited [*name of organization*]'s compliance with requirements applicable to major federal programs, and have issued our report thereon dated August 15, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Non-profit Institutions.* Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and about whether [*name of organization*] complied with laws and regulations, noncompliance with which would be material to a major federal program.

In planning and performing our audits for the year ended June 30, 19XX, we considered [*name of organization*]'s internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on [*name of organization*]'s financial statements and on its compliance with requirements applicable to major programs and to report on the internal control structure in accordance with OMB Circular A-133. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal programs. We have addressed policies and procedures relevant to our audit of the financial statements in a separate report dated August 15, 19XX.

The management of [*name of organization*] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles, and that federal awards programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal programs in the following categories: [*identify internal control structure categories*].[2] For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.[3]

During the year ended June 30, 19XX, [*name of organization*] expended X percent of its total federal awards under major programs.[4,5]

We performed tests of controls,[6] as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements; general requirements; and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the organization's major programs, which are identified in the accompanying schedule of federal awards. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters[7] involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to administer federal awards programs in accordance with applicable laws and regulations.

[*Include paragraphs describing the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that none of the reportable conditions described above is a material weakness.[8]

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[9]

[*Signature*]
[*Date*]

Notes:

1. Describe any departure from the standard report.
2. See paragraph 7.7 for a discussion of categories to be identified. Also, see paragraphs 6.36 and 6.53 through 6.61 for specific and general requirements, respectively.

3. If a cyclical approach is used, the last sentence of this paragraph should be modified and the following paragraph added:

   Because of the large number of nonmajor programs and the decentralized administration of these programs, we performed procedures to obtain an understanding of the internal control structure policies and procedures relevant to nonmajor programs on a cyclical basis. Our procedures during the current year covered X percent of the nonmajor program expenditures administered by the organization as a whole. The nonmajor program expenditures not covered during the current year have been or are expected to be subject to such procedures at least once during the X-year cycle.

4. If the total amount expended under major programs is less than 50 percent of total federal awards expended during the year under audit, the auditor should follow the guidance in paragraph 5.23 of this SOP to satisfy the objectives of OMB Circular A-133. When such guidance is followed, the sixth and seventh paragraphs of this report should be modified as follows:

   During the year ended June 30, 19XX, [*name of organization*] expended X percent of its total federal awards under major programs and the following nonmajor programs: [*list appropriate nonmajor programs*].

   We performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the organization's major programs, which are identified in the accompanying schedule of federal awards, and the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

5. If the organization had no major programs during the year under audit, the auditor should follow the guidance in paragraph 5.25 of this SOP to satisfy the objectives of OMB Circular A-133. When such guidance is followed, the second sentence of the first paragraph of the report, which refers to an audit of compliance with requirements applicable to major programs, would be omitted and the phrase "and about whether [*name of organization*] complied with laws and regulations, noncompliance with which would be material to a major federal program" should be omitted. Also, the phrase "and on its compliance with requirements applicable to major programs" should be omitted from the third paragraph. The sixth and seventh paragraphs of this report should be modified as follows:

   During the year ended June 30, 19XX, [*name of organization*] had no major programs and expended X percent of its total federal awards under the following nonmajor programs [*list appropriate nonmajor programs*]:

We performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

6. When no tests of controls are performed for certain compliance requirements, this paragraph and those that follow should be replaced with the following:

Except as discussed in the following paragraph, we performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the [*name of organization*]'s major federal programs, which are identified in the accompanying schedule of federal awards. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

For [*identify relevant federal programs*], we performed no tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that could be relevant to preventing or detecting material noncompliance with [*identify relevant compliance requirements*]. We did not perform such tests because the results of procedures we performed to obtain an understanding of the design of internal control policies and procedures and whether they have been placed in operation indicated that [*describe the absence of relevant policies and procedures or the circumstances that cause the auditor to conclude that policies and procedures are unlikely to be effective*]. We consider this condition to be a reportable condition under standards established by the American Institute of Certified Public Accountants.

Reportable conditions involve matters coming to our attention concerning significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect [*name of organization*] 's ability to administer federal programs in accordance with applicable laws and regulations. In addition to the reportable conditions identified in the preceding paragraph, we noted other matters involving the internal control structure and its operation that we consider to be reportable conditions.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level of risk that noncompliance with laws and regulations that would be material to a federal program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

7. When there are no material weaknesses and no reportable conditions noted, this paragraph and those that follow should be replaced with the following paragraphs:

Our consideration of the internal control structure policies and procedures used in administering federal awards would not necessarily disclose all matters in the internal control structure that might constitute material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal awards program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*name of organization*]. However, this report is also a matter of public record and its distribution is not limited.

[*Signature*]

[Date]

8. If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the audit of compliance with requirements applicable to major programs. The last sentence of this paragraph of the report should be modified as follows:

    However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of [*name of organization*]'s compliance with requirements applicable to its major programs for the year ended June 30, 19XX, and this report does not affect our report thereon dated August 15, 19XX. [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

9. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-9

Unqualified Opinion on Compliance With Specific Requirements Applicable to Major Programs

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We have also audited [*name of organization*]'s compliance with the requirements governing [*list requirements tested*][2] that are applicable to each of its major federal programs, which are identified in the accompanying schedule of federal awards[3] for the year ended June 30, 19XX. The management of [*name of organization*] is responsible for [*name of organization*]'s compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*name of organization*]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.[4]

In our opinion, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*][1] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[5]

[*Signature*]
[*Date*]

Notes:

1. Describe any departure from the standard report.
2. Specific requirements generally pertain to the following matters:
   - Types of services allowed or not allowed
   - Eligibility
   - Matching, level of effort, or earmarking
   - Reporting
   - Special tests and provisions
   - Financial reports and claims for advances and reimbursements

- Amounts claimed or used for matching

3. Major programs should be clearly identified in the schedule of federal awards.
4. If there are no instances of noncompliance, this paragraph should be omitted. Immaterial instances of noncompliance may be communicated to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the first sentence of this paragraph should be replaced with a sentence similar to the following: "The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."
5. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-10

Qualified Opinion on Compliance With Specific Requirements Applicable to Major Programs—Scope Limitation

[*Addressee*]

[*The first and second paragraphs are the same as those of the standard report on major program compliance illustrated in exhibit D-9.*]

Except as discussed in the following paragraph, we conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards,* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*name of organization*]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain sufficient documentation supporting [*name of organization*]'s compliance with the requirements of [*identify the major program*] governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to [*name of organization*]'s compliance with those requirements by performing other auditing procedures.

[*The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in exhibit D-9.*]

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding [*name of organization*]'s compliance with the requirements of [*identify the major program*] governing types of services allowed or unallowed, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]

[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-11

Qualified Opinion on Compliance With Specific Requirements Applicable to Major Programs—Noncompliance

[*Addressee*]

[*The first three paragraphs are the same as those in the standard report on major program compliance illustrated in exhibit D-9.*]

The results of our audit procedures for [*identify the major program*] disclosed that [*name of organization*] did not comply with the requirement that [*name of organization*] match the funds received from [*identify the major program*]. In our opinion, [*name of organization*]'s matching of funds received from [*identify the major program*] is necessary for [*name of organization*] to comply with the requirements applicable to [*identify the major program*].

[*The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in exhibit D-9.*]

In our opinion, except for those instances of noncompliance with the requirements applicable to [*identify the major program*] referred to in the fourth paragraph of this report and identified in the accompanying schedule of findings and questioned costs, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]
[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-12

Adverse Opinion on Compliance With Specific Requirements Applicable to Major Programs

[*Addressee*]

[*The first three paragraphs of the report are the same as those in the standard report on major program compliance illustrated in exhibit D-9.*]

[*Add a paragraph describing the reasons for the adverse opinion.*]

[*The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in exhibit D-9.*]

In our opinion, because of the noncompliance referred to in the fourth paragraph, [*name of organization*] did not comply, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]
[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-13

Disclaimer of Opinion on Compliance With Specific Requirements Applicable to Major Programs

[*Addressee*]

[*The first paragraph of the report is the same as the first paragraph in the report illustrated in exhibit D-9.*]

We were also engaged to audit [*name of organization*]'s compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs, which are identified in the accompanying schedule of federal awards for the year ended June 30, 19XX. The management of [*name of organization*] is responsible for [*name of organization*]'s compliance with those requirements.

The management of [*name of organization*] has refused to provide us with written representations that generally accepted auditing standards require us to obtain.

Because of the matter described in the preceding paragraph, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on [*name of organization*]'s compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]
[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-14

Qualified Opinion on Compliance With Specific Requirements Applicable to Major Programs—Uncertainties

[*Addressee*]

[*The first three paragraphs are the same as those of the standard report on major program compliance illustrated in exhibit D-9.*]

The results of our audit procedures for the [*name*] program disclosed that [*name of organization*] did not comply with the requirements that [*identify the requirements*]. In our opinion, [*name of organization*]'s compliance with this requirement is necessary for [*name of organization*] to comply with the requirements applicable to the [*name*] program.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to in the second paragraph of this report, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for those instances of noncompliance with requirements applicable to the [*name*] program referred to in the fourth paragraph of this report and identified in the accompanying Schedule of Findings and Questioned Costs, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal programs for the year ended June 30, 19XX.

Resolving instances of noncompliance identified in the fourth paragraph of this report is the responsibility of [*name of organization*] and federal officials. The determination of whether the identified instances of noncompliance will ultimately result in a disallowance of costs cannot be presently determined Accordingly, no adjustment for any disallowances that may result has been made to the federal program amounts listed in the accompanying schedule of federal awards and no provision for any liability that may result has been recognized in [*name of organization*]'s 19XX financial statements.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]
[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-15

Report on Compliance With General Requirements— No Material Noncompliance Identified

[*Addressee*]

We have audited the financial statements of [*name of organization]* as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We have applied procedures to test [*name of organization*]'s compliance with the following requirements applicable to its federal programs, which are identified in the accompanying schedule of federal awards for the year ended June 30, 19XX: [*List the general requirements tested.*[2]].

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of our procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] has not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.[3]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[4]

[*Signature*]
[*Date*]

Notes:

1. Describe any departure from the standard report.
2. General requirements involve the following matters:
   - Political activity
   - Davis-Bacon Act
   - Civil rights
   - Cash management
   - Federal financial reports
   - Allowable costs/cost principles
   - Drug-free workplace
   - Administrative requirements

   The auditor should refer to the Compliance Supplement for additional information on the general requirements.
3. If there are no immaterial instances of noncompliance, this sentence should be omitted. Immaterial instances of noncompliance may be

communicated to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the last sentence of this paragraph should be replaced with a sentence similar to the following: "The results of our procedures disclosed immaterial instances of noncompliance with the requirements referred to above that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."

If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-16

Report on Compliance With General Requirements When Material Noncompliance Is Identified

[*Addressee*]

[*The first three paragraphs are the same as those of the report on compliance with general requirements illustrated in exhibit D-15.*]

Material instances of noncompliance consist of failure to follow the general requirements that caused us to conclude that the misstatements resulting from those failures are material to [*indicate program(s) or financial statements*]. The results of our tests of compliance disclosed the material instances of noncompliance that are described in the accompanying Schedule of Findings and Questioned Costs.[1]

We considered these material instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.[2]

Except as described above, the results of our procedures to determine compliance indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements. However, the results of our procedures also disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.[3]

[*Signature*]
[*Date*]

Notes:

1. If, individually or collectively, the instances of noncompliance are also material to the basic financial statements, the report on compliance required by *Government Auditing Standards* (exhibit D-4) is modified as follows:

   [*First three paragraphs are the same as in the report illustrated in exhibit D-4.*]

   Material instances of noncompliance are failure to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants, that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in the 19X2 financial statements of [*name of organization*].

[*Include paragraphs describing the material instances of noncompliance noted.*]

We considered these material instances of noncompliance in forming our opinion on whether the 19X1 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those provisions.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

2. The following is an illustration of the auditor's report when the auditor determines noncompliance is pervasive and the auditor is not able to provide negative assurance on general requirements.

[*First three paragraphs and last paragraph are the same as in the report illustrated above.*]

With respect to the items tested, [*name of organization*] complied with the requirements listed in the second paragraph, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to items that were not tested by us, there is more than a relatively low risk that [*name of organization*] may not have complied with the requirements referred to in the second paragraph. These matters were considered by us in evaluating whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

3. If the report is not part of public record, this sentence should not be included in the report.

Exhibit D-17

Report on Compliance With General Requirements When a Scope Limitation Exists

[*Addressee*]

[*The first two paragraphs are the same as those of the standard report on compliance with general requirements illustrated in exhibit D-15.*]

Except as described in the following paragraph, our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

We were unable to obtain sufficient documentation of [*name of organization*]'s compliance with [*identify the requirement*] of [*name*] program, nor were we able to satisfy ourselves by alternative procedures as to [*name of organization*]'s compliance with those requirements of [*name*] program.

With respect to the items tested, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding [*name of organization*]'s compliance with the [*identify the requirement*] of [*name*] program, [*name of organization*] complied, in all material respects, with the requirements listed in the first paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements. The results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.[1]

[*Signature*]
[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

Exhibit D-18

Report on Compliance With Specific Requirements Applicable to Nonmajor Program Transactions

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

In connection with our audit of the financial statements of [*name of organization*] and with our consideration of [*name of organization*]'s internal control structure used to administer federal programs, as required by Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions,* we selected certain transactions applicable to certain nonmajor federal programs for the year ended June 30, 19XX. As required by OMB Circular A-133, we performed auditing procedures to test compliance with the requirements governing [*list requirements tested*][2] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of our procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements.[3] However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.[4]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[5]

[*Signature*]
[*Date*]

Notes:

1. Describe any departure from the standard report.
2. See note 2 to exhibit D-9.
3. The following is an illustration of the auditor's report when the auditor determines noncompliance for nonmajor program transactions is pervasive and the auditor is not able to provide assurance.

   [*First two paragraphs and last paragraph are the same as in the report illustrated above.*]

   The results of our tests indicate that, with respect to the items tested, [*name of organization*] complied with those requirements, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to nonmajor program transactions not tested by us, there is more than a relatively low risk that [*name of organization*] may not have complied with the requirements referred to in the preceding paragraph. These matters were considered by us in evaluating whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

4. If there are no instances of noncompliance, this sentence should be omitted. Immaterial instances of noncompliance may be reported to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the last sentence of this paragraph should be replaced with a sentence similar to the following: "However, we noted certain immaterial instances of noncompliance that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."
5. If the report is not part of the public record, this sentence should not be included in the report.

APPENDIX E

Sample Not-for-Profit Organization Schedule of Federal Awards

Community Action Agency
Schedule of Federal Awards
For the Year Ended June 30, 19XX

Federal Grantor/Pass-through Grantor/Program Title	*Federal CFDA Number*	*Agency or Pass-through Number*	*Federal Expenditures*
U.S. Dept. of Health and Human Services			
Headstart (Note B)	93.600	05CH5560/07	$ 237,861
	93.600	05CH5560/08	200,000
Subtotal			437,861*
Pass-through From State Dept. of Human Services			
Community Services Block Grant	93.792	K1578	536,987*
Weatherization (Note A)	93.818	K4599	
Subtotal—U.S. Dept. of Health and Human Services			974,848
Other Federal Awards			
ACTION:			
Pass-through State Department on Aging			
Foster Grandparents	72.001	33924	80,987
Total			$1,055,835

* Denotes a major program

Note A: This item is intended to show that a program can be open without monies being received or expended during the audit period. Such programs should be included in the schedule.

Note B: Although not required, this breakout by grant will facilitate review and make the report more meaningful to users.

Sample University Schedule of Federal Awards* †

Browning Version University
Schedule of Federal Awards
For the Year Ended June 30, 19XX

Federal Grantor/Pass-through Grantor/Program Title	*Federal CFDA Number‡*	*Agency or Pass-through Number*	*Federal Expenditures*
MAJOR PROGRAMS			
Research and Development:			
U.S. Dept. of Health and Human Services:			
Human Genome Research	93.172		$ 400,528
General Clinical Research	93.333		863,561
Biomedical Research Support	93.337		450,218
Other National Institutes of Health	—		780,745
Health Resources and Services Administration	—		477,203
Subtotal			2,972,255
U.S. National Foundation on the Arts and Humanities, National Endowment for the Humanities	—		56,186
U.S. Agency for International Development	—		80,037
Total Research and Development			3,108,478
Student Financial Assistance			
U.S. Dept. of Health and Human Services			
Nursing Student Loan (Note A)	93.364		1,000

* Cost sharing, matching, and grant-related revenue could also be added as a separate column to this schedule.

† The Bureau of Census, Single Audit Clearinghouse, plans to use the Schedule to compile federal assistance by the CFDA number.

‡ CFDA numbers may not be available for all programs (for example, National Endowment for the Humanities and U.S. Agency for National Development).

(Continued)

Federal Grantor/Pass-through Grantor/Program Title	*Federal CFDA Number*	*Agency or Pass-through Number*	*Federal Expenditures*
U.S. Dept. of Education			
Guaranteed Student Loans (Note B)	84.032		0
Pell Grants	84.063		3,006,655
Total Student Financial Assistance			3,007,655
OTHER MAJOR PROGRAMS			
U.S. Dept. of Agriculture:			
Cooperative Extension Service	10.500		3,835,136
Total Major Programs			9,951,269
NONMAJOR PROGRAMS			
Other Federal Assistance			
U.S. National Foundation on the Arts and Humanities			
Institute of Museum Services	—		10,500
National Endowment for the Arts			
Irish Harp Festival	—		5,100
Art Festival	—		11,900
Subtotal			27,500
Pass-through State Dept. of Health			
U.S. Dept. of Agriculture Commodities (Note C)	10.550	587G3	968
Total Other Federal Assistance			28,468
Total Federal Assistance			$9,979,737

Note A: The university administers the following federal loan program:

	CFDA Number	*Outstanding Balance at June 30, 1992*
Nursing Student Loan Program	93.364	$218,629

Total loan expenditures and disbursements of the Department of Health and Human Services student financial assistance program for the fiscal year are identified below:

	CFDA Number	*Disbursements*
Nursing Student Loan Program	93.364	$118,629

The above expenditures for the Nursing Student Loan Program include disbursements and expenditures such as loans to students and administrative expenditures. The Schedule only includes administrative costs of the loan program.

Note B: During the fiscal year ending June 30, 1992, the University processed the following amount of new loans under the Guaranteed Student Loan Program (which includes Stafford Loans, Parents' Loans for Undergraduate Students, and Supplemental Loans for Students):

	CFDA Number	*Amount Authorized*
Guaranteed Student Loans	84.032	$40,036,285

Note C: Nonmonetary assistance is reported in the Schedule based on the amount disbursed or received. As of June 30, 1992, the University had the following nonmonetary inventory:

Food Commodities	$20,000

APPENDIX F

Sample Schedules of Findings and Questioned Costs

Example I:

Guaranteed Student Loan (GSL) Program

—CFDA #84.032

(Questioned Cost—$10,000)

Loans	*Population*[A]		*Sample*[A]		*Non-Compliance*[A]	
Authorized	*Size*	*Value*	*Size*	*Value*	*Size*	*Value*
Stafford	821	$2,328,565	25	$69,600	2	$5,500
SLS	388	$ 970,653	25	$65,000	1	$2,500
PLUS	399	$ 985,306	25	$77,500	1	$2,000

Condition

Four students' files failed to contain a copy of the financial aid transcript from the institution that the student previously attended.

Criteria

Until an institution receives a financial aid transcript from each eligible institution the student previously attended, the institution shall not release GSL or SLS proceeds to a student. [34 CFR 668.19(3)]

Effect

The institution disbursed GSL funds to the students in the amount of $10,000, in violation of the provisions of the GSL program.

Cause

Shortly after the students transferred into the institution, there was a change in personnel in the Student Financial Aid Office, which resulted in this required action to obtain the financial aid transcript to be overlooked.

Recommendation

The University should contact the institution from which the students transferred to obtain the required financial aid transcripts. If the University fails to obtain the required transcripts, or if the transcripts show that any of the students exceeded annual or aggregate aid limits, the University should return all unallowable loan proceeds to the appropriate lender.

University's Comments

We have made contact with the other institutions from which the four students transferred, and have made arrangements for receiving the required financial aid transcripts.

Note A: Presentation of population, sample size, and noncompliance is optional for immaterial findings.

Example II:

Agency for International Development (AID)

(Note: AID has not been assigned a CFDA number)

Interest on Federal Advances and Timely Disbursement of Cash

During 19XX, AID revised its directive on cash management to require that all federal advances be deposited in interest-bearing accounts and that the interest be remitted to the sponsor. The organization maintains interest-bearing domestic accounts and non-interest-bearing foreign accounts. We noted the remittance to the sponsors of interest earned by the organization on domestic cash accounts. As shown in the table below, the organization manages the advances so that additional interest will not be significant, even if all funds are invested in interest-bearing accounts. Overseas, the organization does not always use interest-bearing accounts, because it is not practical in all countries.

In our testing for the timely disbursement of cash drawn on the Federal Reserve Letter of Credit, we noted compliance with reasonable guidelines (within three days for domestic accounts and within thirty days for foreign accounts), as follows:

	Domestic Accounts		*Foreign Accounts*	
	19X1	*19X0*	*19X1*	*19X0*
Drawdowns selected for testing	$675,667	$1,858,588	$2,922,966	$645,758
Drawdowns not fully expended within time guidelines	18%	21%	5%	3%

To be in full compliance with AID directives, the organization should place all funds held overseas in interest-bearing accounts.

Management Response

We believe that the corrective action taken regarding the timely disbursement of cash is sufficient to achieve substantial compliance with AID directives. The monitoring of this control function will be given greater emphasis to increase compliance.

At this time, three of the thirteen field offices maintain interest-bearing accounts. All other field locations have indicated that interest-bearing accounts carry restrictions that would impede their ability to meet operational requirements (that is, restrictions on the receipt of infusions of external funds, the number of withdrawals per month, and the availability of commercial interest-bearing accounts). We will continue our investigation concerning interest-bearing accounts with these offices to determine the appropriate action.

Example III:

Headstart—CFDA 93.600

(Questioned Cost—$16,400)

Finding

The grant financial award stated that the award was for the specific purposes contained in the approved budget. The approved budget specified $15,000 for a van and $1,400 for an audiometer. Neither piece of equipment was purchased as evidenced by the inventory. The funds budgeted for equipment acquisition were used to pay for increased field trips approved by the Department without modification to the budget. This occurred because management did not have adequate procedures in place to monitor proposed expenditures against the budget. The grantee should return the $16,400 expended.

Grantee Comment

The institution concurs with this comment. The $16,400 will be returned to the granting agency and procedures will be established to prevent a recurrence of this situation.

Note: *Follow Up On Prior-Year Findings.* We have reviewed the findings reported in the audit of Browning Version University for the year ended June 30, 19XX. Prior-year findings that have not been corrected are restated in the report and identified as both a current and a prior-year finding. All other findings from prior years have been corrected.

APPENDIX G

Illustrative Audit Engagement Letter

[*Addressee*]

This letter sets forth our understanding of the terms and objectives of our engagement, the nature and scope of the services we will provide, and the related fee arrangements.

We will audit the organization's financial statements as of and for the year ended [*date*], in accordance with generally accepted auditing standards, the standards for financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States and with the provisions of Office of Management and Budget Circular A-133, dated March 16, 1990. The objective of an audit carried out in accordance with such standards and regulations is (1) the expression of our opinion concerning whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the organization in conformity with generally accepted accounting principles; (2) a report on our determination that the internal control structure provides reasonable assurance of compliance with federal and other laws and regulations; and (3) the expression of an opinion on whether the organization complied with specific terms and conditions of its major federal award programs.

As part of our audit, we will consider the organization's internal control structure and assess control risk, as required by generally accepted auditing standards, for the purpose of establishing a basis for determining the nature, timing, and extent of auditing procedures necessary for expressing our opinion concerning the financial statements, and not to provide assurance on the internal control structure. The management of [*name of organization*] is responsible for establishing and maintaining an internal control structure. To fulfill this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs for internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the effectiveness of the design and operation of policies and procedures may deteriorate.

We will prepare a separate written report on our understanding of the organization's internal control structure and the assessment of control risk made as part of the financial statement audit. Our report will include (1) the scope of our work in obtaining an understanding of the internal control structure and in assessing the control risk; (2) the organization's significant internal controls or control structure, including the controls established to ensure compliance with laws and regulations that have a material impact on the financial statements; and (3) the reportable conditions, including the identification of material weaknesses identified as a result of our work in understanding and assessing the control risk. As required by OMB Circular A-133, we will also prepare a written report on our understanding, assessment, and testing of the internal control structure as it relates to major federal award programs.

Our audit will include procedures designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. As you are aware, however, there are inherent limitations in the auditing process. For example, audits are based on the concept of selective testing of the data being examined and are, therefore, subject to the limitation that such matters, if they exist, may not be detected. Also, because of the characteristics of irregularities, including attempts at concealment through collusion and forgery, a properly designed and executed audit may not detect a material irregularity.

Similarly, in performing our audit, we will be aware of the possibility that illegal acts may have occurred. However, it should be recognized that our audit provides no assurance that illegal acts generally will be detected, and only reasonable assurance that illegal acts having a direct and material effect on the determination of financial statements amounts will be detected.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we will perform tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective is not to provide an opinion on overall compliance with such provisions.

As required by *Government Auditing Standards,* we will prepare a separate written report on our tests of compliance with applicable laws and regulations. This report will contain a statement of positive assurance on those items that were tested for compliance, negative assurance on those items not tested, and a description of all material instances of noncompliance.

Likewise, compliance with provisions of laws, regulations, contracts, and grants that govern federal programs is the responsibility of management. As required by OMB Circular A-133, we will determine and report on whether the organization complied in all material respects with the laws and regulations that apply to its major federal award programs. With regard to transactions selected from nonmajor programs, our report on compliance will obtain a statement of positive and negative assurance, as discussed above.

At the conclusion of the engagement, [*name of organization*]'s management will provide to us a representation letter that, among other things,[1] will confirm management's responsibility for the preparation of the financial statements in conformity with generally accepted accounting principles, the availability of financial records and related data, compliance with provisions of laws, regulations, contracts, and grants that govern federal programs, the completeness and availability of all minutes of board of directors (and committee) meetings, and the absence of irregularities involving management or those employees who have significant roles in the control structure.

We understand that our reports on the internal control structure as part of the financial audit and on compliance with laws and regulations are intended for the information of the audit committee, management, and other within [*name of organization*] and [*specify legislative or regulatory body*].

Our fees for the audit will be [*describe fee arrangement*]. We anticipate completing the engagement by [*describe timetable*], unless unexpected factors are encountered. This timetable has been discussed with and agreed to by your [*internal audit and*] accounting department[s], which will provide assistance to us in the audit. Should circumstances prevent [*name of organization*] from providing this assistance, our timetable and fee are likely to be affected. [*On fixed-fee engagements, the auditor may include wording indicating that he or she may have to revise the fee estimate and timetable for unexpected factors of which he or she becomes aware after the engagement has begun.*]

We shall be pleased to discuss this letter with you.

[*Signature*]
[*Date*]

Note:

1. Other matters may be included. This sample letter should be modified as necessary.

Glossary

AICPA. American Institute of Certified Public Accountants.

AID. Agency for International Development.

Award. Defined in OMB Circular A-133 as federal financial assistance (see below) and federal cost-type contracts used to buy services or goods for the use of the federal government. It includes both awards received directly or indirectly through recipients (pass-through funds). It does not include procurement contracts to vendors under grants or subcontracts used to buy goods or services.

CFDA. Catalog of Federal Domestic Assistance.

CFR. Codified Federal Regulation.

Cognizant agency. A federal agency designated by the OMB to provide general oversight of an organization that receives federal funds. Cognizant agencies have certain specified responsibilities, including the coordination of audits of the organization; see the section entitled "Responsibilities of the Cognizant Agency" in chapter 3 of this SOP.

Compliance Supplements. Published by the OMB as a supplement to OMB Circular A-128, *Compliance Supplement for Single Audits of State and Local Governments* (revised in April 1990). It specifies the general and specific program compliance requirements and suggested audit procedures for sixty-two federal financial assistance programs. The OMB published a supplement to OMB Circular A-133, *Compliance Supplement for Audits of Institutions of Higher Learning and Other Nonprofit Institutions.*

Coordinated audit approach. An audit wherein the independent auditor, and other federal and nonfederal auditors, consider each other's work in determining the nature, timing, and extent of his or her own auditing procedures. A coordinated audit must be conducted in accordance with *Government Auditing Standards* and meet the objectives and reporting requirements set forth in paragraphs 12(b) and 15, respectively, of the Attachment to Circular A-133. The objective of the coordinated audit approach is to minimize duplication of audit effort, but not to limit the scope of the audit work so as to preclude the independent auditor from meeting the objectives set forth in paragraph 12(b) or issuing the reports required in paragraph 15 in a timely manner. (Also referred to as a joint audit, although this term more commonly refers to audits carried out by two or more independent CPA firms.)

CPE. Continuing Professional Education.

Cyclical approach. Method by which the auditor obtains an understanding of internal control structure policies and procedures applicable to nonmajor programs over a number of years when multiple operating components of an NPO administer a large number of nonmajor programs. Each nonmajor program for which the cyclical approach is used should be covered at least once every three years. In the first year of the review cycle, the auditor should obtain an understanding of the internal control structure policies and procedures for any program of which he or she has not obtained an understanding. Also, the auditor should obtain an understanding of policies and procedures for new nonmajor programs the first year that the program is active. If a cyclical approach is used, the auditor's report on the internal control structure should be modified to clearly describe the coverage provided for nonmajor programs.

FAR. Federal Acquisition Regulations.

Federal financial assistance. Assistance provided to an organization by a federal agency in such forms as grants of cash and other assets, loans, loan guarantees, and interest-rate subsidies. The term includes pass-through assistance but does not include direct federal cash assistance to individuals.

Findings. *Government Auditing Standards* defines findings as the result of information development—a logical pulling together of information about an organization, program, activity, function, condition, or other matter that was analyzed or evaluated. It also states that factual data supporting all findings should be presented accurately and fairly in the auditor's report and that these findings should be adequately supported by sufficient evidence in the working papers.

FSR. Financial status report.

GAAP. Generally accepted accounting principles.

GAAS. Generally accepted auditing standards.

GAO. The United States General Accounting Office. Its main purposes are to (1) assist Congress in carrying out legislative and oversight responsibilities; (2) carry out legal, accounting, auditing, and claims-settlement functions with respect to federal government programs; and (3) make recommendations to provide for more efficient and effective government operations.

GAS. *Government Auditing Standards.*

General requirements. Described in the Compliance Supplements as "those requirements that involve significant national policy and of which failure to comply could have a material impact on an organization's financial statements." Accordingly, tests for compliance with these requirements "should be included as a part of every audit of state, local, and tribal governments that involves federal financial assistance."

HHS. U.S. Department of Health and Human Services.

Joint audit. An audit for which the recipient of federal funds, the cognizant (or largest funding) agency, and the auditors have agreed on their respective audit scope. (Also referred to as a coordinated audit.)

Major program. A program in which total expenditures are the larger of 3 percent of total federal funds expended or $100,000. Each of the following categories of federal award constitutes a major program if over the threshold:

1. Research and development
2. Student financial assistance
3. Individual awards not in the student aid or research-and-development category

Nonmajor program. Defined by the Single Audit Act as any federal award program that does not meet the specified criteria of a major program.

NPO. Non-profit (or Not-for-profit) organization.

OASC. Office of Assistant Secretary, Comptroller.

OMB. The United States Office of Management and Budget.

OMB Circular A-21, *Cost Principles for Educational Institutions.* Issued to provide that federal assistance programs provided to educational institutions bear their fair share of costs by defining costs that are allowable and unallowable for that assistance.

OMB Circular A-110, *Uniform Requirements for Grants to Universities, Hospitals and Other Nonprofit Organizations.* Issued to establish standards (such as insurance requirements, record retention requirements, banking requirements, and so on) for maintaining consistency and uniformity among federal agencies in the administration of grants to and agreements with public and private institutions of higher education, public and private hospitals, and other quasi-public and private nonprofit organizations. It does not apply to grants, contracts, and other agreements between the federal government and units of state and local governments.

OMB Circular A-122, *Cost Principles for Nonprofit Organizations.* Issued to provide that federal assistance programs provided to nonprofit organizations bear their fair share of costs by defining costs that are allowable and unallowable for that assistance. This circular does not apply to—

1. Colleges and universities.
2. State, local, and Indian tribal governments.
3. Hospitals.

OMB Circular A-128, *Audits of State and Local Governments.* Issued to facilitate the implementation of the Single Audit Act of 1984. It establishes audit requirements and defines federal responsibilities for implementing and monitoring these requirements.

OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* Establishes audit requirements and defined federal responsibilities for implementing and monitoring federal requirements.

Organization-wide audit. Under Circular A-133, it has two main components—an audit of the financial statements and an audit of federal awards. Each component results in a variety of audit reports. The single-audit concept is described in Circular A-133 as an organization-wide audit.

Oversight agency. The federal agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency. For those entities that do not receive any direct funding, the federal agency with predominant indirect funding will assume the responsibilities of the oversight agency. The oversight agency may assume some or all of the responsibilities normally performed by a cognizant agency.

Pass-through funds. Funds received by subrecipients indirectly from the federal government through a primary recipient.

PCIE. President's Council on Integrity and Efficiency.

Provider. A person or entity that undertakes to provide health care services.

Questioned costs. Defined in the Inspector General Act Amendments of 1988 as (1) an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds; (2) a finding that, at the time of the audit, such cost is not supported by adequate documentation; or (3) a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.

R&D. Research and development.

SAS. Statement on auditing standards.

SFA. Student financial aid.

Single Audit Act of 1984. The United States statute (Public Law 98-502) that establishes uniform requirements for audits of federal financial assistance provided to state and local governments. These requirements focus on a single coordinated audit of the aggregate federal financial assistance programs. The requirements include—

1. An audit of the general-purpose financial statements.
2. Additional tests for compliance with applicable laws and regulations related to federal assistance programs received.
3. Reviews of the internal control system for federal financial assistance received.

SOP. Statement of position.

Specific requirements. Defined in the Compliance Supplement as those requirements that pertain to the following categories:

1. Types of services allowed or not allowed
2. Eligibility
3. Matching, level of effort, or earmarking
4. Reporting
5. Special tests and provisions

Subrecipient. An entity receiving government financial assistance when the assistance is initially received by another entity that distributes the assistance for the government program that created and provided the assistance.

Appendix C

Schedule of Changes Made to Audits of Colleges and Universities

Reference	Change	Date
General	The term "examination" has been changed to "audit" to conform to the terminology used in SAS No. 58.	October, 1990
General	The terminology used to refer to "internal controls" has been changed to "internal control structure" to conform to SAS No. 55.	October, 1990
Paragraph 1.02	References to the Financial Accounting Standards Board and Governmental Accounting Standards Board added.	October, 1990
Paragraph 1.06	Reference to FASB Statement No. 93 added.	October, 1990
Paragraph 1.07	Paragraph added to make reference to GASB Statement No. 8.	December, 1991
Paragraph 1.21	Reference to Governmental Accounting Standards Board added.	December, 1991
Paragraph 2.04	Reference to reporting guidance based on SAS No. 1 replaced with references to SAS Nos. 58 and 62.	October, 1990
Paragraph 2.22	Reference to FASB Statement No. 93 added.	October, 1990
Paragraph 2.23	Paragraph added to make reference to GASB Statement No. 8.	December, 1991
Paragraphs 5.01—5.20	Paragraphs deleted.	April, 1992
Paragraphs 6.01—6.22	Paragraphs deleted.	April, 1992
Paragraph 7.06	Reference to the Department of Health, Education and Welfare changed to the Department of Education.	April, 1992
Paragraph 8.14	Reference to FASB study of total return concept as part of project on accounting for marketable securities deleted.	October, 1990
Paragraph 11.02	Footnote reference to FASB Statement No. 95 added.	October, 1990
Paragraph 11.02 (Footnote *)	Footnote reference updated.	December, 1991
Paragraph 11.11	Reference to SAS No. 1, section 546 changed to SAS No. 58.	October, 1990
Paragraphs 11.14—11.19	Illustrative financial statements deleted.	April, 1992

Reference	Change	Date
Chapter 12	References and illustrative reports conformed to SAS Nos. 58 and 62; Opinions and Compliance Reporting on Material Defense Student Loan Funds and College Work—Study Programs replaced with reference to U.S. Department of Education Student Financial Assistance Programs Audit Guide.	October, 1990
Appendix A	Footnote updated.	October, 1990
Appendix A	Notice to Readers revised to reflect SAS No. 69.	April, 1992
Appendix A	Notes to financial statements updated to: add footnote reference to FASB Statement No. 47 to note 3 (long-term debt); delete note 4 (pension plans) and add references to FASB Statement No. 87 and GASB Statement No. 5.	May, 1992
Appendix A	Illustrative exhibits paragraph modified.	April, 1993
Appendix B	SOP 92-9 added.	February, 1993

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