

1991

Proposed statement of position : audits of not-for-profit organizations receiving federal awards; Audits of not-for-profit organizations receiving federal awards; Exposure draft (American Institute of Certified Public Accountants), 1991, Aug. 30

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

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# **EXPOSURE DRAFT**

## **PROPOSED STATEMENT OF POSITION**

### **AUDITS OF NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS**

**(Amendment to AICPA Audit and Accounting Guides  
*Audits of Voluntary Health and Welfare Organizations,  
Audits of Colleges and Universities, and Audits of Certain  
Nonprofit Organizations*)**

**AUGUST 30, 1991**

**Proposed by the Not-for-Profit Organizations Committee  
American Institute of Certified Public Accountants**

**Comments should be received by November 25, 1991, and addressed to  
Douglas P. Sauter, Technical Manager, AICPA Auditing Standards Division, File 3605  
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775**

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Nonprofit Organizations*)**

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**Proposed by the Not-for-Profit Organizations Committee  
American Institute of Certified Public Accountants**

August 30, 1991

Accompanying this letter is an exposure draft of a proposed auditing statement of position (SOP), Audits of Not-for-Profit Organizations Receiving Federal Awards. It has been prepared by the Not-for-Profit Organizations Committee. A summary of the proposed SOP also accompanies this letter.

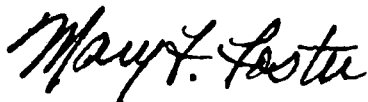
The purpose of this exposure draft is to solicit comments from independent auditors, government auditors, administrators of federal award programs, and other interested parties. This proposed SOP has been developed to amend certain AICPA audit and accounting guides to provide guidance on conducting an audit in accordance with Office of Management and Budget (OMB) Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions.

On April 9, 1991, the Auditing Standards Board issued a proposed statement on auditing standards (SAS) that would revise certain of the guidance provided in SAS No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance. The Auditing Standards Board expects to complete the proposed revisions to SAS No. 63 by issuing a final SAS in the fourth quarter of 1991. It is the committee's intent that the final issuance of this proposed SOP will reflect the guidance in that final SAS. Where appropriate, this proposed SOP refers to guidance proposed by the exposure draft of that SAS as SAS No. 6X.

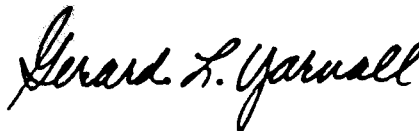
Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate consideration of responses by the committee, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the AICPA after December 25, 1991, for one year. Responses should be sent to Douglas Sauter, Technical Manager, Auditing Standards Division, File Ref. No. 3605, 1211 Avenue of the Americas, New York, New York, 10036-8775, in time to be received by November 25, 1991.

Sincerely,



Mary Foster  
Chairwoman  
1989-91 Not-for-Profit  
Organizations Committee



Gerard L. Yarnall  
Director  
Audit and Accounting Guides

## SUMMARY

This proposed 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 Non-profit Institutions. This proposed SOP would amend the following AICPA audit and accounting guides:

- o Audits of Voluntary Health and Welfare Organizations
- o Audits of Colleges and Universities
- o Audits of Certain Nonprofit Organizations

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

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

This exposure draft has been sent to--

- o Practice offices of CPA firms.
- o State society and chapter presidents, directors, and committee chairmen.
- o Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.
- o Persons who have requested copies.

**Not-for-Profit Organizations Committee  
(1989 - 1991)**

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Douglas P. Sauter  
Technical Manager,  
Auditing Standards Division

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## CHAPTER 1

### INTRODUCTION AND OVERVIEW

#### INTRODUCTION

##### Purpose and Applicability

1.1 The purpose of this proposed 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 (the Yellow Book), issued by the Comptroller General of the United States (also referred to as GAS).
- b. Office of Management and Budget (OMB) Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions.<sup>1</sup>

1.2 This proposed 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. To be consistent with that purpose, this guide, instead of creating unique requirements, consolidates applicable audit requirements established by these organizations in order to facilitate efficient and effective compliance. In addition, this proposed SOP provides suggestions for implementing these requirements and includes illustrative audit reports.

1.3 This document is not a complete manual of procedures, nor should it supplant the auditor's judgment of the audit work required in a particular situation. Because of the variety of federal, state, and local financial assistance programs and the complexity of the regulations that govern them, the procedures contained in this proposed SOP cannot cover all the circumstances or conditions that would be encountered in an audit of every organization. The auditor should use professional judgment to tailor his or

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<sup>1</sup> Some of the guidance in this statement may be helpful for compliance testing in audits of not-for-profit organizations that are performed in accordance with generally accepted auditing standards and in which the auditor does not issue a written report on compliance with laws and regulations. Paragraphs 3 through 16 of AICPA Statement on Auditing Standards No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance (AICPA, Professional Standards, vol. 1, AU sec. 801), describe the auditor's responsibility for testing compliance with laws and regulations in an audit conducted in accordance with generally accepted auditing standards (GAAS). Appendix B of this proposed SOP explains how to obtain these and other relevant publications.

her procedures to meet the conditions of the particular engagement so that the audit objectives may be achieved.<sup>2</sup>

#### EFFECTIVE DATE

1.4 The provisions of this proposed SOP are effective for audits in accordance with OMB Circular A-133 for periods ending on or after June 15, 1992. Early application of this proposed SOP is permissible.

1.5 During the preparation of this proposed SOP, the AICPA conferred with representatives of federal and other sponsors of programs for NPOs, with the OMB and the GAO, and with managers of NPOs. It is intended that an audit carried out in accordance with this proposed SOP would comply with requirements of generally accepted auditing standards (GAAS), including AICPA Statement on Auditing Standards (SAS) No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance (AICPA, Professional Standards, vol. 1, AU sec. 801); Government Auditing Standards; and OMB Circular A-133.<sup>3</sup>

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

1.6 Figure 1 presents the relationship among the compliance testing requirements of GAAS, Government Auditing Standards, and OMB Circular A-133 (for the requirements of this circular, see chapter 2 of this proposed SOP). SAS No. 6X defines the auditor's responsibility to understand and assess audit risk related to compliance, and to design audit procedures to detect noncompliance in the course of performing 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.

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<sup>2</sup> The auditor should refer to relevant AICPA audit and accounting guides, which might include Audits of Voluntary Health and Welfare Organizations, Audits of Colleges and Universities, and Audits of Certain Nonprofit Organizations.

<sup>3</sup> OMB Circular A-133 is reprinted in Appendix A of this proposed SOP.

FIGURE 1

AUDITING COMPLIANCE WITH LAWS AND REGULATIONS

Organization-Wide Audits in Accordance With Circular A-133

Procedures Performed

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

*Specific Requirements:*

*Major programs:* Audit of compliance with specific requirements applicable to major federal awards

*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

Testing of compliance with laws and regulations in accordance with generally accepted auditing standards and reporting thereon

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. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance

1.7 Government Auditing Standards is to be followed when required by law, regulation, agreement or contract, or policy.<sup>4</sup> In performing an audit in accordance with Government Auditing Standards,<sup>5</sup> the auditor assumes certain reporting responsibilities beyond those of an audit performed in accordance with generally accepted auditing standards. Thus, Government Auditing Standards incorporates 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. In addition to requirements for written reports on compliance and the internal control structure in all audits, Government Auditing Standards includes quality-control, continuing education, and specific working-paper requirements.

#### Nature and Purpose of an Organization-Wide Audit

1.8 America's hundreds of thousands of not-for-profit organizations 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.

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<sup>4</sup> SAS No. 6X, (AICPA, Professional Standards, vol. 1, AU sec. XXX), describes the auditor's responsibility when he or she has been engaged to perform an audit in accordance with generally accepted auditing standards and becomes aware that by law, regulation, or contractual agreement, the entity is required to have its financial statements audited in accordance with Government Auditing Standards, or to have an audit in accordance with the Single Audit Act of 1984, OMB Circular A-128, or OMB Circular A-133. In such a situation, the statement requires that the auditor communicate to management that an audit in accordance with generally accepted auditing standards alone may not satisfy the relevant legal, regulatory, or contractual requirements. That communication may be oral or written. However, if the communication is oral, the auditor must document that in the audit workpapers.

<sup>5</sup> Government Auditing Standards includes standards for financial audits as well as for performance audits. The references to Government Auditing Standards in this proposed SOP encompass only the standards for financial audits and not the performance audit standards. However, Government Auditing Standards notes that the "report 'Contents' and 'Presentation' standards, which are included in the section describing performance audit standards, may also apply for some financial audits."

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. OMB Circular A-128, Audits of State and Local Governments, is the policy that implements the Single Audit Act. All federal agencies are required to adopt the requirements of Circular A-128. OMB Circular A-133,<sup>6</sup> which was patterned after Circular A-128, was issued in 1990. Both Circulars A-128 and A-133 provide guidance to implement 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 \$100,000 in federal awards are subject to Circular A-133.<sup>7</sup> An organization-wide audit under Circular A-133 has two main components--an audit of the financial statements (paragraphs 1.11 of this proposed SOP) and an audit of federal awards (paragraphs 1.12 and 1.13 of this proposed 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 figure 2.

1.11 Financial Statement Audit. The financial statement audit generally required by OMB Circular A-133 is performed in accordance with GAAS and GAS, and results in a report on the financial statements. The primary sources of guidance and standards regarding the auditing of the financial statements of not-for-profit organizations are the AICPA Statements on Auditing Standards, particularly SAS No. 63; Government Auditing Standards; and the AICPA audit and accounting guides Audits of Voluntary Health and Welfare Organizations, Audits of Colleges and Universities, and Audits of Certain Nonprofit Organizations.

1.12 Audit of Federal Awards. In performing an audit in accordance with OMB 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 upon certain of their testing and reporting requirements. The additional responsibilities focus on compliance with laws and regulations and on the internal control structure over federal awards. The terms single audit, organization-wide audit, and entity-wide audit are frequently used

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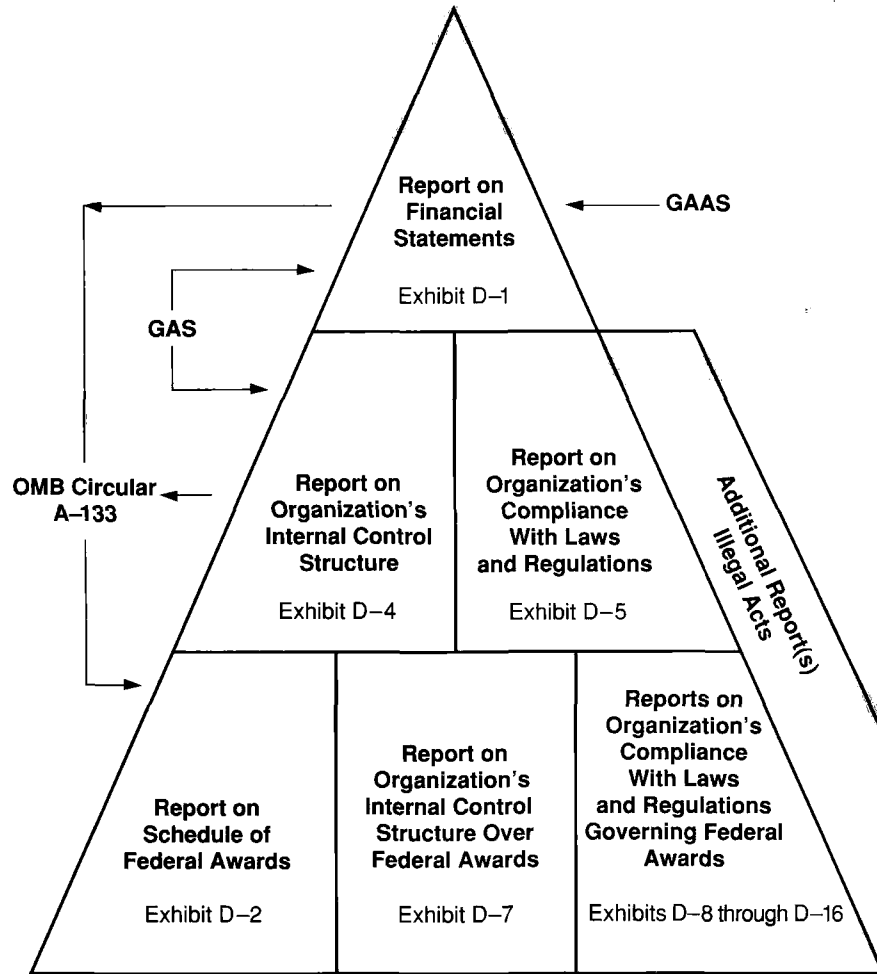
<sup>6</sup> The audit requirements of OMB Circular A-133 supersede those for certain entities described in attachment F, subparagraph 2h, of Circular A-110, Uniform Administrative Requirements--Grants and Agreements with Institutions of Higher Education, Hospitals and Other Nonprofit Organizations. 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.

<sup>7</sup> Organizations receiving awards of \$100,000 or more under only one program have the option of having a program-specific audit. See paragraphs 96 and 97 of SAS No. 6X.



FIGURE 2

LEVELS OF REPORTING IN ORGANIZATION-WIDE AUDITS



interchangeably by practitioners when they refer to the more extensive form of federal financial assistance auditing required by Circular A-133.

1.13 The audit of federal awards specified in Circular A-133 provides a basis for issuing reports on the internal control structure and on compliance in addition to those required by GAAS and GAS. 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 proposed SOP.

#### 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 OMB Circular A-133.

1.15 Size--Major vs. Nonmajor Programs. Before an audit begins, the NPO should identify the programs<sup>8</sup> under which it receives federal awards, both to prepare the required supplementary schedule of federal awards (see paragraph 5.33 of this proposed SOP) and to identify which programs are "major" and "nonmajor" for audit purposes. The type of reports issued, and therefore the audit work required, in an audit performed under OMB Circular A-133 depends on whether financial awards received by the organization 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:

- o Research and development
- o Student financial aid
- o Individual awards not in the research-and-development or student financial-aid categories

1.16 Any federal program with insufficient expenditures to be considered a major program is a nonmajor program. As will be shown, the auditor's responsibilities for major programs generally are greater than those for

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<sup>8</sup> 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. In general, awards that carry a particular CFDA number constitute a program. OMB Circular A-133, however, specifies that awards in two defined categories--student financial assistance, and research and development--be classified as separate programs. It is possible that a more limited grouping--types of research and development, for instance--may be appropriate, in the auditor's judgment. In addition, it may be appropriate in some circumstances to aggregate other awards by program groups that include more than one CFDA number--perhaps similar awards from different agencies. It is not expected that awards will be grouped below the CFDA-number level, however.

nonmajor programs. Additional guidance in determining whether a program is major or nonmajor is provided in paragraph 2.12 of this proposed SOP.

#### Compliance Requirements

1.17 Paragraph 13(c)(1) of OMB 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.

1.18 The form in which the auditor expresses the results of his or her determination is discussed in SAS 63 and depends on the evidence generated and the type of compliance requirement. For certain requirements, it is expected that the audit will generate evidence that supports an examination-level attestation (an "opinion") on compliance. For others, the auditor is not expected to express an opinion, but rather to provide "positive assurance" on items tested and "negative assurance" on those not tested.

1.19 The OMB has published "compliance supplements" which set forth the compliance requirements that federal agencies consider most significant to the auditor in making this determination. 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.

1.20 The auditor should obtain enough evidence to support an opinion on applicable program-specific requirements set forth in paragraphs 13(c)(4) and (5) of Circular A-133. There is no requirement, however, that the auditor design his or her procedures to support an opinion on any of the general requirements.<sup>9</sup> Instead, the work should suffice for the auditor to issue a "positive and negative assurance" report on compliance with the general requirements on an organization-wide level. The auditor should use professional judgment in determining the extent of testing appropriate in each set of circumstances.

1.21 Specific Requirements. Specific requirements are those that, if not complied with, could have a material effect on a federal program and generally pertain to the following matters:

- o "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.
- o "Eligibility," which specifies the characteristics of individuals or groups to whom entities may give financial assistance.

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<sup>9</sup> For example, an opinion on whether the recipient's affirmative action program complied with federal requirements governing civil rights.

- o "Matching, level of effort, or earmarking," which specifies amounts entities should contribute from their own resources toward projects for which financial assistance is provided.
- o "Reporting," which specifies reports that entities must file in addition to those required by the general requirements.
- o "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; and still other programs set a deadline for the expenditure of federal awards.)

1.22 The principal compliance requirements for the largest federal programs are contained in the Compliance Supplement for Single Audits of Nonprofit Organizations or the Compliance Supplement for State and Local Governments (compliance supplements), issued by the OMB and available from the Government Printing Office. The compliance supplements were issued to assist auditors in performing organization-wide audits and supplement OMB Circular A-133.<sup>10</sup> Both compliance supplements describe specific requirements for many of the larger federal financial assistance programs and suggest procedures for testing compliance with the specific requirements. For other programs, compliance requirements may be found by researching the statutes, regulations, and agreements governing individual programs.

1.23 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. Auditors may refer to the statute or Code of Federal Regulations 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 specific requirements may change periodically, and auditors should be alert to this possibility by maintaining contact with the federal agencies or the audited organizations, by referring to subscription services, or by other means. The federal inspectors general or the cognizant agency, if one is assigned, could provide assistance in this regard. There are several publication services that report on current developments and provide updates to the laws and regulations governing federal awards. These services may be useful to the auditor in determining new or revised compliance auditing requirements.

1.24 To obtain an understanding of specific requirements of programs not included in the compliance supplements, the auditor should consider reviewing the Catalog of Federal Domestic Assistance (CFDA). Generally updated on an annual basis, the CFDA contains all federal financial assistance programs, and

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<sup>10</sup> The OMB expects to issue the Compliance Supplement for Single Audits of Nonprofit Organizations in 1991. This section will be revised to conform with any changes to the final Compliance Supplement.

cites applicable laws and regulations associated with these programs. It also provides the names of program staff who serve as contacts for each program.

1.25 As described in chapter 5 of this proposed SOP, Circular A-133 requires that the auditor provide an opinion on an organization's compliance with specific requirements of its major programs. Additionally, Circular A-133 requires the auditor to determine whether--

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

1.26 General Requirements. In addition to the specific requirements, the compliance supplements also identify nine general compliance requirements that apply to all federal award programs. These requirements are--

- o Political activity (Hatch Act and Intergovernmental Personnel Act of 1970, as amended).
- o Construction contracts (Davis-Bacon Act).
- o Civil rights.
- o Cash management.
- o Relocation assistance and real property acquisition.
- o Federal financial reports.
- o Drug-free workplace.
- o Allowable Costs and Cost Principles.
- o Administrative requirements (Circular A-110).

1.27 The nature of the procedures specified in the compliance supplements is sufficient to satisfy the requirements of OMB Circular A-133 with respect to the general requirements. However, the compliance supplements do not specify the extent of such procedures. Although the audit procedures suggested for these general compliance requirements are included in the compliance supplements, the auditor should evaluate his or her understanding and assessment of the control environment governing programs and exercise professional judgment in determining the extent of procedures for testing compliance with the general requirements.

1.28 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. According to the OMB, administrative requirements affecting the following matters could have a material effect on a federal program:

- o Interest earned on advances
- o Period of availability of funds
- o Equipment
- o Supplies
- o Subawards to debarred and suspended parties
- o Program income
- o Procurement
- o Subgrants
- o Real Property

1.29 The auditor should exercise professional judgment in deciding if other administrative requirements would be relevant in an organization-wide audit of federal awards of an NPO.

1.30 As described in chapter 4 of this proposed SOP, the auditor is not required to provide an opinion on an organization's compliance with the general requirements, but rather to issue a report that describes procedures, provides positive assurance on items tested and negative assurance on items not tested, and describes instances of noncompliance with the general requirements.

#### THE AUDITOR'S RESPONSIBILITIES IN AUDITS OF FEDERAL AWARDS--AN OVERVIEW

1.31 The extent of the auditor's tests of the operating effectiveness of internal controls 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 matrix at the end of this chapter graphically depicts how program size and compliance requirements determine the scope of the auditor's work and the reports he or she issues.

#### The Internal Control Structure Used in Administering Federal Awards

1.32 In audits of federal awards conducted as part of an organization-wide audit under OMB Circular A-133, the auditor is concerned with internal control structure policies and procedures relevant to assuring 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.

1.33 For all major programs, the auditor should document this understanding and assessment, and he or she should test the operating effectiveness of internal control structure policies and procedures ("test controls") relevant to assuring 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 can use in determining the nature and extent of testing necessary to express an opinion on compliance with specific requirements applicable to major programs.

1.34 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 test controls over larger nonmajor programs so that at least half of the total federal expenditures have been subjected to tests of controls.

1.35 For the remaining federal programs, the auditor's work is limited to obtaining an understanding of the relevant internal control structure policies and procedures. This work may include inquiries, observations, or walk-throughs. In some circumstances, 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 if multiple operating components of an NPO administer a large number of nonmajor programs. For a cyclical approach to be acceptable, 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. 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.

#### Compliance With Laws and Regulations

1.36 The interaction between the size of the program and the type of 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. A summary of these responsibilities and a discussion of the schedule of findings and questioned costs appear subsequently. Detailed guidance on carrying out these responsibilities is presented in chapter 4 of this proposed SOP; chapter 5 discusses the schedule of findings and questioned costs.

#### Specific Requirements

1.37 Major Programs. The auditor should obtain sufficient evidence to support an opinion on compliance with the specific requirements applicable to each major program. Evidence obtained from tests of controls, as described previously, may form part of the basis for determining the nature and extent

of testing necessary to express an opinion on compliance with the specific requirements.

1.38 Nonmajor Programs. If the auditor selects nonmajor program transactions during the financial statement audit or in the course of the internal control work done in an audit of federal awards, he or she should test the transactions for compliance with specific requirements applicable to them. Typically, the auditor would test compliance with eligibility and allowability requirements applicable to the selected nonmajor program transactions. The auditor's report on nonmajor program transactions should provide positive assurance about items tested and negative assurance about items not tested.

#### General Requirements--Major and Nonmajor Programs

1.39 The auditor should perform tests of compliance for all of the general requirements applicable to federal awards. SAS No. 6X established that the nature of the procedures suggested in the compliance supplements is sufficient to satisfy the requirements of OMB Circular A-133 with respect to the general requirements. Typically, many of these procedures would be performed as part of dual-purpose tests in the course of the internal control work done in an audit of federal awards. The auditor's report should provide positive assurance about items tested and negative assurance about items not tested.

1.40 The auditor should test and report on compliance with general requirements regardless of whether or not the organization being audited has major programs. Although the compliance supplements deal with the nature of audit procedures, determining the extent of any tests of compliance with general requirements is a matter of professional judgment. Among the matters the auditor considers is the extent of any tests of compliance with general requirements performed for major programs. If the organization being audited has no major programs or where major program expenditures do not constitute at least 50 percent of the total federal expenditures, 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 any of the general requirements are applicable to the entity but have not been tested, the auditor should perform tests of compliance with the applicable requirement.

#### Findings and Questioned Costs

1.41 The auditor's tests of compliance with laws and regulations may disclose instances of noncompliance or "questioned costs." Under OMB 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 paragraph 15 of Circular A-133. The auditor should describe immaterial findings in a separate letter to the organization. Paragraph 15 of Circular A-133 requires management to submit a copy of this letter 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.



**FIGURE 3  
AUDIT MATRIX**

	Major Programs Exceed 50%		Major Programs Less Than 50%		No Major Programs	
	Major Internal Control Compliance	Nonmajor Internal Control Compliance	Major Internal Control Compliance	Normajor to achieve 50% Internal Control Compliance	Normajor to achieve 50% Internal Control Compliance	Other Nonmajor Programs Internal Control Compliance
<b>GENERAL REQUIREMENTS</b>	T +/-	U B (2)	T +/-	T B (2)	T B (2)	U B (2)
<b>SPECIFIC REQUIREMENTS</b>	T Opinion	U B (1)	T Opinion	T B (1)	T B (1)	U B (1)

- Legend**
- +/- = Positive/Negative Assurance
  - B = No Work Performed
  - T = Understand/Assess Risk/Test Controls
  - U = Understand Control Structure and Assess Control Risk

**Note**  
(1) If as part of the audit of the general purpose financial statements or as a result of the understanding and assessment of the internal control structure, the auditor selects a transaction from a nonmajor federal award program, the auditor is required to test that transaction for compliance with the specific compliance requirements and special tests and provisions applicable to that transaction. This testing, in turn, allows the user to issue a report (positive/negative assurance) relative to the nonmajor programs.

(2) If any of the general requirements are applicable to the entity but have not been covered, the auditor needs to ensure that each of the applicable requirements is tested.

## Audit Matrix

1.42 The matrix presented in Figure 3 summarizes how the relative size of a program (that is, major or nonmajor) and the type of compliance requirement (that is, specific or general) determine the scope of work and the reports issued for both the internal control and compliance aspects of an audit of federal awards.

1.43 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 governmental 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 Ethics, unless it is disclosed in the auditor's report that these rules were not followed and the reasons therefor are given.

1.44 Overview of This Proposed SOP. The requirements of OMB Circular A-133 are set forth in chapter 2 of this proposed SOP. Chapter 3 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 4 describes compliance auditing requirements. Chapter 5 sets forth reporting considerations.

## CHAPTER 2

### REQUIREMENTS OF OMB CIRCULAR A-133

#### APPLICABILITY

2.1 The applicability of OMB Circular A-133 to an organization depends on (a) the type of organization and (b) the amount of federal awards it receives.

#### Type of Institution

2.2 OMB Circular A-133 defines a nonprofit 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.

2.3 Accordingly, the institutions covered by Circular A-133 include colleges and universities (and their affiliated hospitals) and community-based organizations such as voluntary health and welfare organizations. Circular A-133 does not apply to--

- o Colleges and universities covered by Circular A-128.
- o Hospitals not affiliated with a college or university.<sup>1</sup>
- o State and local governments and Indian tribes covered by Circular A-128.

#### Amount of Federal Awards

2.4 OMB Circular A-133 applies to organizations that directly or indirectly receive federal awards above a certain threshold. 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, loan guarantees, property, cooperative agreements, interest subsidies, insurance, direct appropriations, and other noncash

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<sup>1</sup> Hospitals not affiliated with a college or university that were subject to OMB Circular A-110's audit requirement, for example, community hospitals, are subject to statutory audit requirements of Medicaid and Medicare, or other programs in which they participate.

assistance. The term includes pass-through assistance but does not include direct federal cash assistance to individuals.<sup>2</sup>

2.5 The following chart sets forth the requirements of OMB Circular A-133 for those types of institutions described in paragraphs 2.2 and 2.3 of this proposed SOP, based on the amount of awards received:<sup>3</sup>

What Is the Total Amount  
of Federal Awards Received  
in a Year?

Is the Organization  
Required to Follow 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 that program's requirements.

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.

Less than \$25,000

No. Records must be available for review by appropriate officials.

#### REQUIREMENTS OF OMB CIRCULAR A-133

2.6 The requirements of OMB Circular A-133 include an audit of the entity's general-purpose or basic financial statements, the performance of additional audit tests for compliance with applicable laws and regulations, and reviews of the organization's internal control structure over federal financial assistance.

2.7 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.

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<sup>2</sup> For purposes of this proposed SOP, Medicare payments are considered payments to individuals. Further, although Medicaid funds paid by the federal government to the states are considered to be financial assistance to the states, most Medicaid arrangements between the states and health-care providers are contracts for services that are not considered to be financial assistance to the health-care providers.

<sup>3</sup> The definition of a receipt is based on how a recipient recognizes and reports its revenue. Generally, a recipient has received awards when it has obtained cash, or when it has incurred expenditures that will be reimbursed under a federal program. For those organizations following GAAP, receipt of federal awards occurs when the assets or revenues are recorded in the financial statements.

2.8 Circular A-133 requires the auditor to determine whether--

- o The financial statements of an NPO present fairly its financial position and the results of its financial operations in accordance with GAAP.<sup>4</sup>
- o The organization has an internal control structure (a) to provide reasonable assurance that it is managing federal awards in compliance with applicable laws and regulations and (b) to ensure compliance with laws and regulations that could have a material impact on the financial statements.
- o The organization has complied with laws and regulations that may have a direct and material effect on its financial statement amounts and those that may have a direct and material effect on each major federal program.

#### DIFFERENCES BETWEEN OMB CIRCULARS A-110 AND A-133

2.9 Attachment F, subparagraph 2(h), of OMB Circular A-110 contained a general requirement for an organization-wide financial audit, to be carried out at least biennially. Since the attachment to Circular A-110 contained no specific reporting requirements, its application was diverse in practice. Circular A-133 set forth the audit requirements described previously.

2.10 In 1989, the Standards Subcommittee of the President's Council on Integrity and Efficiency (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 the Department of Health and Human Services. In summary, its reporting requirements include the internal control and compliance reports of GAS, but do not include the separate internal control and compliance reports specified by OMB Circular A-133. Although the audit requirements of Circular A-133 supersede those of OMB Circular A-110, auditors may find the 1989 audit guide a useful source of information, especially for compliance audits of federal programs not included in the compliance supplements.

#### DIFFERENCES BETWEEN OMB CIRCULARS A-128 AND A-133

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

##### Defining Major Programs

2.12 Major programs are defined differently in OMB Circular A-133 than they are in Circular A-128. The threshold of Circular A-133 (see paragraph 1.15 of

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<sup>4</sup> Other bases of accounting other than GAAP are acceptable. See paragraphs 5.4 through 5.6 of this proposed SOP.

this proposed SOP) is somewhat different from the one specified by Circular A-128. For organizations that had \$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 organizations that spent more than \$100 million, Circular A-128 has a chart that specifies the amounts used to define major programs.

2.13 Under Circular A-133, a program may include several grants, contracts, and other forms of federal financial assistance. For example, federal student financial aid consists of a variety of grants, loans, and guarantees under various federal awards. Under Circular A-128, 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.

#### Disclosure of Immaterial Findings

2.14 Unlike OMB Circular A-128, Circular A-133 does not require the auditor to include a description of immaterial findings of noncompliance in the audit reports. However, under Circular A-133, immaterial findings of noncompliance are required to be reported in a separate written communication to the institution.

#### Frequency of Audit

2.15 OMB Circular A-133 permits audits to be conducted every two years. 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.

#### Coordinated Audit

2.16 Another difference arises from the provision in OMB Circular A-133 for a "coordinated audit." 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.

2.17 In most cases, the objectives of GAAS and Circular A-133 can be achieved most effectively by a single auditor, which meets 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, auditors should cooperate with other auditors to determine whether they have any work planned, in process, or completed that may be used to satisfy some or all of their needs in performing planned work, to avoid duplication of efforts. Such work includes that 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 requirements, including the objectives and reporting requirements described in paragraphs 12(b) and 15 of that circular.

2.18 In such cases, 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 (AICPA, Professional Standards, vol. 1, AU sec. 336); and SAS No. 1, Codification of Statements on Auditing Standards (AICPA, Professional Standards, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors").

2.19 A coordinated audit contemplates different auditors providing various reports required by paragraph 15 of Circular A-133. For example, one auditor may provide the report on the financial statements, another the compliance reports, and another the remaining reports. 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 the reporting responsibilities.

2.20 In designing such audits, cognizant agencies may, in certain cases, request special reports prepared in accordance with SAS No. 62, or additional 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 any additional reporting requirements, and consider documenting this understanding in an engagement letter signed by all parties, before beginning fieldwork.

#### ADDITIONAL AUDIT WORK

2.21 OMB 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. OMB Circular A-73 states in part:

Reports prepared by nonfederal auditors will be used in lieu of federal audits if the reports and supporting work papers are available for review by federal agencies, if testing by federal agencies indicates that the audits are performed in accordance with generally accepted auditing standards (including the audit standards issued by the Comptroller General), and if the audits otherwise meet the requirements of federal agencies.

2.22 The provisions of Circular A-73 do not limit the authority of a federal agency to conduct or contract for additional audits of a recipient organization. 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.

#### SMALL AND MINORITY AUDIT FIRMS

2.23 OMB 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

2.24 OMB 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

2.25 Additional guidance has been provided by the Standards Subcommittee of the PCIE and by the AICPA. Appendix B of this proposed SOP lists this guidance and explains how to obtain the publications. In the planning stage of the audit, auditors should become familiar with the applicable documents presented in appendix B, many of which are discussed further in this proposed SOP.



## CHAPTER 3

### CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE

#### CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN AN AUDIT CONDUCTED IN ACCORDANCE WITH GAAS

3.1 SAS No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 319), 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 the financial statements, including those of a not-for-profit organization, 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 have been placed in operation. For example, if the auditor determines that certain matching requirements, which specify amounts that an organization should contribute from its own resources to projects receiving financial assistance from the state, have a direct and material effect on the determination of financial statement amounts, then he or she should obtain an understanding of the internal control structure policies and procedures relevant to compliance with these requirements.

3.2 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 misstatement.
- c. Design substantive tests.

3.3 SAS No. 55 also requires the auditor to assess control risk for the assertions embodied in the financial statements. 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 following elements of a control environment may influence the auditor's assessment of control risk:

- o Management's awareness, or lack of awareness, of relevant laws and regulations.
- o Organization policy regarding such matters as acceptable operating practices and codes of conduct.

- o Assignment of responsibility and delegation of authority for dealing with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- o 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.
- o A limited number of staff personnel, which sometimes may be too small to provide for appropriate segregation of duties.
- o A volunteer governing board, many of whose members serve for limited terms.
- o A budget approved by the governing board. The budget may serve as authorization for management to carry out activities in order to attain an organization's program objectives. Many nonprofit organizations prepare budgets for both operating and capital expenditures.

#### Initial Field Audit Procedures

3.4 Before initiating field work in a GAAS audit, the auditor should obtain an understanding of the organization's internal control structure. Procedures to obtain an understanding include the following:

- o 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.
- o Obtain a schedule of federal awards and understand what major and nonmajor programs exist and the related general and specific requirements.
- o 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.
- o 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.
- o Tour the organization and meet its key employees.

- o Obtain management's list of applicable laws and regulations and assess it for completeness.
- o Obtain an understanding of the internal control structure related to the federal awards.

3.5 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 (AICPA, Professional Standards, vol. 1, AU sec. 325).

#### CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN AN AUDIT CONDUCTED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

3.6 Except for meeting 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 5.7 of this proposed SOP. Government Auditing Standards requires auditors to prepare a written report on their understanding of an entity's internal control structure and their assessment of control risk in accordance with SAS No. 55. 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 paragraphs 5.7 through 5.16 of this proposed SOP and paragraphs 30 through 39 of SAS No. 63.

#### CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN AN AUDIT CONDUCTED IN ACCORDANCE WITH OMB CIRCULAR A-133

3.7 OMB Circular A-133 establishes additional audit requirements beyond those of an audit conducted in accordance with generally accepted auditing standards and Government Auditing Standards. These requirements are discussed in the following paragraphs.

#### The Internal Control Structure Used in Administering Federal Awards

3.8 OMB 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. These internal controls will be referred to throughout the remainder of this proposed SOP as the internal control structure over federal awards to distinguish them from the larger internal control structure of which they are a part.

3.9 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.

3.10 In addition to these basic controls, Circular A-110 and other federal pronouncements such as program handbooks and guides outline uniform administrative requirements for grants and agreements with not-for-profit organizations. 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, close-out procedures, suspensions and terminations, applications for federal assistance, and standards for property management and procurement. These procedures go beyond the control policies and procedures for distribution of salaries, invoice clearance, account reporting, cost transfers, and other journal entries. In certain cases, weaknesses in administrative procedures (such as those regarding cash receipts, cost sharing, procurement, property management, and financial reporting) may be significant to the operation of federally sponsored programs. Consequently, the OMB has considered these administrative requirements as a general requirement in the compliance supplements.

3.11 Although Circular A-133 requires a report on the internal control structure, it does not require the auditor to express an opinion on the internal control structure over federal awards.

3.12 The auditor should perform the following procedures regarding the internal control structure used in administering federal awards:

- o Test the effectiveness of the design and operation of the internal control structure policies and procedures for preventing or detecting material noncompliance.<sup>1</sup>
- o Review the recipient's system for monitoring subrecipients and obtaining and acting on subrecipients' audit reports.
- o Determine whether controls to ensure that direct and indirect costs were computed and billed in accordance with the general requirements in effect.

3.13 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

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<sup>1</sup> Tests of controls are not required for those areas in which the internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance. In such cases, a reportable condition should be reported (see paragraph 3.16 of this proposed SOP).

which follows, has been developed in consultation with representatives of the OMB, the GAO, and the PCIE.

### Major Programs

3.14 For major programs as defined in OMB 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 the following requirements:

- a. Specific requirements that are applicable to those programs and address 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 49 through 51 of SAS No. 63.
- b. General requirements addressing civil rights, political activity, cash management, the Davis-Bacon Act, relocation assistance and real property management, federal financial reports, allowable costs and cost principles, the Drug-Free Workplace Act, and certain administrative requirements. Paragraphs 80 through 82 of SAS No. 63 discuss these nine general requirements.
- c. Requirements governing claims for advances, reimbursements, and amounts claimed or used for matching, as discussed in paragraph 52 of SAS No. 63.

3.15 The auditor should consider the results of these tests of controls in evaluating control risk in the process of forming a basis for expressing an opinion on compliance with laws and regulations applicable to major programs, as discussed in paragraphs 58 through 62 of SAS No. 63.

3.16 The tests of controls performed should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55. 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. Tests of controls may be omitted only in those areas in which the internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance, in which case a reportable condition should be reported. For purposes of Circular A-133, 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. A reportable condition may be of such magnitude as to be considered a material weakness. 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 do not reduce, to a relatively low level, the risk that either errors or irregularities in amounts that would be material in relation to the financial statements being audited

or 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.

#### Nonmajor Programs

3.17 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 perform tests of controls over all major 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 paragraphs 3.12 through 3.15 of this proposed SOP.

3.18 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 to preventing or detecting material noncompliance with the requirements listed in paragraph 3.14 of this proposed SOP. The understanding should incorporate knowledge about the design of relevant policies, procedures, and records, and about whether the organization has placed them in operation. In obtaining this understanding, the auditor is not required to obtain knowledge about operating effectiveness. Paragraph 1.35 describes a cyclical approach to the auditor's consideration of the internal control structure.

3.19 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 3.14 through 3.16 of this proposed SOP, for the largest 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 3.18 of this proposed SOP.

3.20 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. Based on the auditor's understanding of the controls and procedures and the results of the testing performed, the auditor draws a conclusion regarding the entity's internal control structure. The steps performed and conclusions reached should be clearly evidenced in the auditor's working papers.

3.21 Tests of controls, which provide evidence of the design and operation of the controls and procedures, ordinarily include (a) inquiries of appropriate personnel, including grant 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. If the auditor determines that there is a significant risk that material noncompliance has occurred, additional testing is probably necessary to determine the effect of control weaknesses on

expenditures of federal financial assistance. This strategy follows the general approach provided by SAS No. 55.

3.22 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. The auditor's working papers should also clearly provide evidence of the tests of controls performed.

## CHAPTER 4

### COMPLIANCE AUDITING

#### COMPLIANCE AUDITING ENVIRONMENT

4.1 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.

4.2 Although it is management's responsibility to identify relevant laws and regulations, the auditor often must invest considerable effort in researching and understanding various compliance requirements, in adequately training audit personnel, and in satisfying the oversight responsibilities of cognizant government agencies at all levels. (Government Auditing Standards includes certain requirements for continuing professional education in the compliance auditing environment; see chapter 6 of this proposed SOP.) Paragraph 8 of SAS No. 63 describes steps that the auditor should take to understand compliance requirements. Given the environment, auditors should consider including a description of the type of engagement in any proposal, contract, or engagement letter. For those organizations that have a cognizant agency, such a description would appropriately include statements about whether the engagement is intended to meet a cognizant or oversight agency's requirements.

4.3 A wide spectrum of other compliance requirements may apply to NPOs. The requirements vary from state to state and among the several different forms of NPOs. Appendix C of this proposed 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 WITH GAAS

4.4 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.

4.5 SAS No. 63 describes the auditor's responsibility for considering laws and regulations and their effect on an audit. Paragraphs 3 and 4 of SAS No. 63 reiterate the auditor's responsibility for detecting misstatements caused by illegal acts, errors, and irregularities. Paragraph 5 states:

[. . . 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 8 and 9 of SAS No. 63 describe the auditor's responsibility to understand the effect of laws and regulations, and to consider the related audit risk.

4.6 According to SAS No. 63, the independent auditor of a not-for-profit organization should--

- o 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.
- o Become familiar with those laws and regulations that could have a direct and material effect on financial statement line item amounts.
- o Understand the characteristics of those laws and regulations that, if they are not followed, could potentially lead to a misstatement on the financial statements.
- o Assess the risk that a material misstatement has occurred because of such noncompliance.
- o Design and conduct an audit to provide reasonable assurance of detecting such material noncompliance.

4.7 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. Discussions with these individuals should focus on compliance matters included in laws and regulations, including the bylaws, that may require testing. If appropriate, contact should be made with a state auditor or an appropriate oversight body to obtain a perspective on key areas of compliance applicable to constituent communities, including state statutes, regulations, and uniform reporting requirements. In addition, the following approaches may be helpful in identifying compliance requirements:

- o 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.
- o Review materials available from other professional organizations, such as state societies of CPAs.
- o Identify sources of revenue received by an entity 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.

- o Obtain copies of and review pertinent sections of the state constitution and state laws relative to the organization. The sections of these documents pertaining to debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- o 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.

4.8 Once the auditor has obtained an understanding of the laws and regulations to which an organization is subject, he or she should assess the risk of material noncompliance. In order to assess this risk, the auditor should obtain an understanding of the possible nature of noncompliance with identified laws and regulations and the potential consequences. 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 weaknesses in the internal control structure.

4.9 Based on this risk assessment, the auditor should plan the audit to provide reasonable assurance of detecting instances of noncompliance with identified laws and regulations that 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 achieve reasonable assurance that illegal acts having a direct and material effect on the financial statements will be detected.

4.10 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.

4.11 Paragraph 16 of SAS No. 63 notes that the auditor should consider obtaining, as part of the written representations from management required by SAS No. 19, Client Representations (AICPA, Professional Standards, vol. 1, AU sec. 333), 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

4.12 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.

4.13 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 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 generally accepted auditing standards provides no assurance that these violations will be detected or that any contingent liabilities that may result will be disclosed. Examples of such 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.

4.14 The auditor should gain an understanding of these types of laws and regulations, assess the risk of noncompliance, and make inquiries of management regarding its identification of and compliance with them; merely remaining alert to the possibility of noncompliance is not sufficient. Unlike in the case of direct-effect acts, however, no tests aimed specifically at detecting noncompliance need to be designed or executed unless as a result of the limited procedures described previously, information comes to the auditor's attention that indicates a need for testing, or unless testing is required by the audit contract. Additionally, the auditor should consider addressing these types of laws and regulations in the engagement letter and audit contract.

## COMPLIANCE AUDITING REQUIREMENTS OF GOVERNMENT AUDITING STANDARDS

4.15 While incorporating GAAS as described in paragraph 1.7 of this proposed SOP, Government Auditing Standards also requires that the auditor issue a written report on compliance with laws and regulations that may have a direct and material effect on financial statement amounts. Paragraphs 20 through 31 of SAS No. 6X provide guidance on reporting on compliance with applicable laws and regulations.

## COMPLIANCE AUDITING REQUIREMENTS OF OMB CIRCULAR A-133

4.16 In addition to the requirements of GAAS and Government Auditing Standards, OMB 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]). With regard to compliance at the financial statement level, Circular A-133 does not require that the auditor extend his or her procedures beyond the extent required by GAAS and Government Auditing Standards, as described in paragraphs 4.4-4.15 of this proposed SOP.

4.17 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. 63, the opinion should cover allowability, eligibility of program beneficiaries, matching, federal financial reports, and special tests and provisions. The audit should address those specific requirements that could have a direct and material effect on the financial results at the major program level. 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.

4.18 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.

4.19 Laws and regulations that could have a direct and material effect on the financial results of these major programs include specific program requirements (for example, those regarding needs analysis for students receiving financial aid) and certain general requirements, such as those pertaining to allowability of claims for reimbursement and financial reports.

4.20 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, rather than test compliance with laws and regulations that have a direct and material effect on the financial statements, the auditor tests 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.

4.21 Once informed of the 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 considers the compliance requirements in three ways:

- a. Through inquiry, observation, and testing at the organizational level
- b. Through procedures directed at the major program level
- c. Through tests of transactions

4.22 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.

4.23 The audit required by OMB Circular A-133 includes the selection and testing of an adequate number of 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.

4.24 The selection and testing of transactions are based on the auditor's professional judgment regarding factors such as--

- o The amount of expenditures for the program.
- o The length of time that the program has operated, or changes in its conditions.
- o 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).
- o The extent to which the program is carried out through subrecipients.
- o The extent to which the program contracts for goods or services.
- o The level to which the program is already subject to program reviews or other forms of independent oversight.
- o The adequacy of the controls for ensuring compliance.
- o The expectation of adherence or lack of adherence to the applicable laws and regulations.
- o The potential impact of adverse findings.

#### MAJOR PROGRAM COMPLIANCE

4.25 To support his or her opinion on compliance with the specific requirements applicable to each major program, the auditor is required to select an adequate number of representative charges from each major program and to test them for compliance with the specific requirements of that program. This testing provides the basis for the auditor's opinion on compliance illustrated in exhibit D-8 of this proposed SOP. In determining the number of items to select, the auditor should assess materiality in relation to the individual major program being tested. Materiality should not be measured for the major programs taken as a whole or in relation to the general-purpose financial statements. In many cases, the assessed level of materiality for an individual major program is less than either of the other calculations.

## NONMAJOR PROGRAM TESTING

4.26 In connection with the audit of the financial statements or with the consideration of the internal control structure over federal awards, the auditor may have selected for testing transactions from federal programs other than major programs. For the issuance of a report on compliance with the requirements applicable to nonmajor program transactions, OMB 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 reported on in accordance with exhibit D-15 of this proposed SOP.

4.27 The specific requirements for which nonmajor program compliance should be tested generally relate to the allowability of the program expenditure and the eligibility of the individuals or groups to whom the NPO provides federal financial assistance. For example--

- o If, in the audit of the general-purpose 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.
- o 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, and whether the travel allowance was within administratively prescribed limits. The auditor would not be required to test the transactions for general compliance with, for example, the civil-rights or cash-management limitations.
- o 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 allowed services and whether the individual or organization was eligible. The auditor would not be required to test the transaction for general compliance with, for example, civil-rights or cash-management limitations.

## AUDIT SAMPLING

4.28 As noted above, OMB Circular A-133 requires the auditor to select and test a sufficient number of transactions that would support an opinion on compliance 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 (AICPA, Professional Standards,

vol. 1, AU sec. 350), 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.

4.29 Auditors conducting audits of NPOs generally use audit sampling to perform four types of tests:

- o Tests of controls that the auditor applies to obtain evidence about the operating effectiveness of the internal control structure
- o Substantive tests performed as part of the audit of the organization's general-purpose or basic financial statements in accordance with GAAS
- o Tests of controls to provide reasonable assurance that control procedures used in administering federal awards are being applied as prescribed
- o Tests of compliance with laws and regulations performed as part of the audit of the general-purpose or basic financial statements and for the purpose of reporting on compliance with laws and regulations as they relate to the schedule of federal awards

In some cases, the auditor may find it possible to use a single sample to achieve these objectives.

#### IDENTIFYING COMPLIANCE REQUIREMENTS--THE COMPLIANCE SUPPLEMENT

4.30 The auditor may ascertain the principal compliance requirements for the largest federal programs by referring to the OMB's Compliance Supplement for Single Audits of Non-Profit Organizations. For programs not listed, the auditor may refer to the OMB's Compliance Supplement for State and Local Governments or to the regulations and agreements governing individual programs.

4.31 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.

#### COMPLIANCE TESTING--SPECIFIC REQUIREMENTS

4.32 In the course of testing transactions, the auditor is required by OMB Circular A-133 to determine 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.

4.33 In addition to transaction testing, Circular A-133 requires the auditor to determine whether--

- o Matching requirements, levels-of-effort, and earmarking limitations were met.
- o Federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the general-purpose or basic financial statements were prepared.
- o Amounts claimed or used for matching were determined in accordance with (a) Circular A-21, (b) matching or cost-sharing requirements in Circular A-110, (c) Circular A-122, (d) 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.

For example, in auditing a major student financial aid program at a liberal arts 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

4.34 The transactions selected by the auditor from each major program should be reviewed to determine whether the costs meet the criteria of the cost principles that apply to that program. The auditor's working papers should document the applicable criteria reviewed, the results of the procedures performed, and the conclusion reached by the auditor.

4.35 The cost principles set forth in OMB Circulars A-21 and A-122 and in HHS OASC-3 establish principles and 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 following nine basic criteria:

- o Costs should be reasonable and necessary for the proper and efficient performance and administration of the federal award(s). Necessary costs include expenditures for goods or services that are for the program charged, in quantities considered normal for the nature of the program, and at a reasonable cost. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs.
- o Costs should be authorized or allowable under state and local laws and regulations. Costs incurred that violate the terms and



conditions of an award are unallowable regardless of whether such costs meet other requirements of HHS OASC-3, if applicable, or OMB Circulars A-21 and A-122. Charges should conform to any limitations or exclusions set forth in the cost principles or in the award regarding types or amounts of cost items. The organization may have agreed that certain costs will be considered unallowable for a specific program. For example, an award might disallow or limit any indirect costs or restrict the use of a portion of the grant funds for a specific purpose.

- o Costs should be consistent with the policies, regulations, and procedures that apply uniformly to both federally assisted and other activities of the NPO. The charges should receive the same accounting treatment and be applied consistently to both federal and nonfederal activities.
- o Costs should be treated consistently. For example, a cost may not be charged as a direct cost to a federal program if any other cost incurred for the same purpose in similar circumstances has been charged to a federal program through an indirect cost proposal or cost-allocation plan.
- o In general, costs should be determined in accordance with generally accepted accounting principles appropriate for the circumstances.
- o Costs should not be included as costs, or used to meet cost-sharing or matching requirements, of any other federally supported activity in either the current or a prior period.
- o Charges should be 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.
- o 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 will be considered allowable. The understanding preferably should be in writing and approved by the awarding or cognizant agency in advance of the expenditure; otherwise the costs may be disallowed.

- o If subject to prior approval in accordance with HHS OASC-3, OMB Circulars A-21 or A-122, or 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 the purchase of equipment, and for foreign travel. In addition, an award agreement may require advance approval for other specific costs.
- o Costs should be net of all applicable credits. Federal program costs should be reported net of applicable credits. The term applicable credits refers to those receipts or reductions of expenditures that offset or reduce expense items that are allocable to federal programs as direct or indirect costs. These credits include, but are not limited to, rental income, sales of assets purchased with grant funds, purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds, and adjustments of overpayments or erroneous charges.
- o Costs should be adequately documented. To satisfy the source-documentation requirements, the auditor needs to examine the evidence supporting the types of costs, the purposes for which they were incurred, the times they were incurred, the amounts of such costs (itemized to the extent necessary), and approvals in accordance with management's directives. In reaching a conclusion on the adequacy of the source documentation, the auditor should assess the nature, competence, and sufficiency of evidential matter.

4.36 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 proposal. 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 OMB compliance supplements.

#### OTHER TESTING CONSIDERATIONS

4.37 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. He or she should use professional judgment in determining the appropriate audit procedures.

4.38 An auditor may also be engaged to test and report on compliance with state and local laws and regulations. Paragraphs 98-100 of SAS No. 6X 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 single-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

4.39 The compliance supplements identify general requirements with which the auditor should test for compliance in all OMB Circular A-133 audits. The auditor is not expected to express an opinion on an organization's compliance with the general requirements. Rather, as described in paragraph 4.57 and exhibit D-14 of this proposed SOP, the report provides positive and negative assurance and sets forth procedures and material findings. The general requirements are described in the following paragraphs.

4.40 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.

4.41 Davis-Bacon Act. All construction programs are required to follow the provisions of the Davis-Bacon Act, which in general requires that laborers and mechanics employed by contractors of federally funded projects be paid at wages not less than those established by the Secretary of Labor as the prevailing regional wage rate.

4.42 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.

4.43 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.

4.44 Relocation Assistance and Real Property Acquisition. Federal financial assistance programs that require the acquisition of property by a public agency and subsequent displacement of households and businesses provide that such recipients carry out certain actions.

4.45 Federal Financial Reports. Attachment H of OMB Circular A-110 requires that recipients of federal financial assistance file four financial reports for each federal financial assistance program. Paragraphs 4.49 through 4.52 of this proposed SOP cover the review of federal financial reports.

4.46 Allowable Costs and Cost Principles. These principles prescribe the direct and indirect costs allowable for federal reimbursement.

4.47 Drug-Free Workplace. This law prescribes that organizations certify that they provide a drug-free workplace.

4.48 Administrative Requirements. These prescribe administrative requirements that should be followed.

## Review of Federal Financial Reports

4.49 In connection with tests of compliance with applicable laws and regulations, OMB 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.

4.50 The auditor should compare the statement of expenditures incurred under federally-sponsored programs with the books and records of the organization and, as a part of his or her testing of the financial-reporting system, compare the books and records with periodic financial reports to the federal government for sampled items.

4.51 Attachment H describes the following reports that recipients should prepare and submit to the federal government:

- o A financial status report
- o A federal cash-transactions report
- o A request for advance or reimbursement
- o An outlay report and a request for reimbursement for construction programs

4.52 Individual federal financial assistance agreements may contain the specific reporting requirements to be followed by the recipient. However, attachment H establishes the standard financial-reporting requirements for all federal financial assistance programs. Auditors should become familiar with the detailed instructions and the recipient government's system for preparing and submitting federal financial reports.

## Drug-Free Workplace

4.53 Beginning on March 18, 1989, all grantees directly receiving grants, including cooperative agreements, from any federal agency are required to certify that they will provide a drug-free workplace as a precondition of receiving the grants. All grantees, except for states, are required to make the certification for all grants they receive. 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.

## Administrative Requirements (OMB Circular A-110)

4.54 OMB Circular A-110 contains various administrative requirements with which NPOs should comply. The requirements of Circular A-110 apply to federal assistance in the forms of grants and cooperative agreements. Federal assistance in the form of entitlements is subject to the standard

administrative requirements of the Department of Health and Human Services or the Department of Agriculture. Contracts are covered by their own terms and conditions.

4.55 The auditor should obtain an understanding of the internal control structure, assess control risk, and test internal control structure policies and procedures relative to the provisions of the Administrative Requirements (OMB Circular A-110). Because certain provisions of the Administrative Requirements duplicate certain general and specific compliance requirements sections of the compliance supplements, they do not need to be addressed separately. However, the auditor should obtain an understanding of the internal control structure policies and procedures relative to the material provisions of the administrative requirements not addressed in the general and specific requirements.

#### OTHER GENERAL REQUIREMENT TESTING CONSIDERATIONS

4.56 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. The testing allows the auditor to provide positive assurance on the requirements tested for compliance and negative assurance for items not tested.

4.57 To support the report on an organization's compliance with general requirements, the auditor should test compliance with the general requirements applicable to federal awards. It should be noted that when major programs do not exist or when major program expenditures do not constitute 50 percent of the total federal expenditures, the auditor should test the controls over the general requirements related to the nonmajor programs included in the understanding and assessment of the internal control structure over those federal programs. If the auditor plans to use a dual-purpose test for this purpose (that is, one that is designed to meet the objectives of both a test of controls and a substantive test of the requirements), such testing may be sufficient to support the issuance of a report on the general requirements related to those nonmajor programs.

4.58 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 do 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.

4.59 As noted above, the suggested audit procedures for these general requirements are included in the compliance supplements. The auditor should note that paragraph 50 of SAS No. 6X provides for a report that describes procedures performed and provides positive and negative assurance on items

tested and negative assurance on items not tested and describes instances of noncompliance with the general requirements. The auditor should use professional judgment in deciding whether to perform additional or alternative tests and procedures for determining the adherence, or lack of adherence, to a general requirement.

#### CRITERIA FOR QUESTIONING COSTS

4.60 When performing an audit in accordance with generally accepted auditing standards, the auditor should consider the impact 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 OMB Circular A-133 to issue reports on compliance with requirements applicable to federal awards. Examples of compliance reports are presented in appendix D of this proposed SOP.

4.61 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:

- o Unallowable Costs. Certain costs are specifically unallowable under the general and special award conditions or agency instructions. (They may include, but are not limited to, pre-grant and postgrant costs and costs in excess of the approved grant budget, either by category or in total.)
- o Undocumented Costs. These costs are charged to the grant, for example, to demonstrate their relationship to the grant or the amounts involved, but they lack adequate, detailed documentation.
- o Unapproved Costs. These costs are not provided for in the approved grant budget, or they require the awarding agency's approval due to the grant or contract provisions or applicable cost principles, but no evidence of such approval can be found.
- o Unreasonable Costs. These are costs incurred that may not be consistent with the actions that a prudent person would take in the circumstances, or 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.

4.62 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 major program.
- b. Assess the projected error against the materiality level established for the individual major program.

4.63 If the auditor determines that the actual error is material to the individual major program, then, depending on the circumstances, the auditor's report should be modified. If the projected error is material to the individual program, the auditor needs to consider whether additional audit procedures should be applied or whether an opinion modification is warranted.

4.64 Auditors also have the responsibility of assessing the impact of the actual and projected error noted in the testing on the financial assistance programs against the materiality level established for the basic financial statements. SAS No. 47, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1, AU sec. 312.31), 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.

4.65 OMB 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 general-purpose or basic financial statements. Financial Accounting Standards Board (FASB) Statement No. 5, Accounting for Contingencies, as amended and interpreted, provides guidance on accruing and disclosing contingent liabilities.

4.66 The auditor is required to report material questioned costs to the grantor agency for disposition. 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.

4.67 The auditor should evaluate the effect of reportable conditions and noncompliance on all levels of reporting.

#### REPORTING ILLEGAL ACTS

4.68 OMB Circular A-133 requires the auditor to report any illegal acts as set forth in Government Auditing Standards.

4.69 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 28 and 29 of SAS No. 63 (AICPA, Professional Standards, vol. 1, AU sec. 801.28-29). Further, the auditor should refer to pages 5-4 through 5-6 of Government Auditing Standards to be satisfied that the appropriate parties are informed of illegal acts. (See paragraphs 5.20 through 5.25 of this proposed SOP.)

#### CLIENT REPRESENTATIONS--AUDITS PERFORMED UNDER OMB CIRCULAR A-133

4.70 Paragraph 90 of SAS No. 6X specifies 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 be obtained in an organization-wide audit include the following:

- 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 unallowed: eligibility; matching, level of effort, or earmarking; reporting (including any special provisions); 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 with reporting requirements in connection with federal awards.
- e. Information presented in federal financial reports and claims for advances and reimbursements is supported by the books and records from which the basic financial statements have been prepared.
- f. Amounts claimed 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 laws and regulations and have met the requirements of OMB 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 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 and known noncompliance with requirements that could have a material effect on a major program.

## CHAPTER 5

### REPORTING

#### CHAPTER OVERVIEW

5.1 Government Auditing Standards and OMB Circular A-133 broaden the auditor's responsibility to include reporting not only on an institution's financial statements but also on its internal control structure and its compliance with laws and regulations. To fulfill this added responsibility, the auditor should issue additional audit reports. This chapter presents an overview of the required compliance reports and the auditor's consideration of the internal control structure in audits performed in accordance with Government Auditing Standards and those in accordance with Circular A-133. A pyramid depicting the reports required by GAAS, GAS, and OMB Circular A-133 appears as figure 2 of chapter 1 of this proposed SOP. Auditors need to understand the intended purpose of each report and should tailor the reports to their specific audit situation. The standard reports are illustrated in appendix D of this proposed SOP. Modifications to the standard reports for circumstances such as uncertainty are also presented in appendix D. The related audit reports presented in appendix D are referenced throughout this chapter.

#### REPORTS REQUIRED BY GOVERNMENT AUDITING STANDARDS

5.2 The following reports should be issued in an audit performed in accordance with Government Auditing Standards:

- o A report on an audit of the general-purpose or basic financial statements of an entity as a whole
- o A report on internal control structure policies and procedures that is based solely on an understanding of the internal control structure and assessment of control risk obtained as a part of the audit of the general-purpose or basic financial statements
- o A report on compliance with laws and regulations that may have a direct and material effect on financial statement amounts

#### The Auditor's Report on the Basic Financial Statements

5.3 Financial reporting under Government Auditing Standards includes an organization's basic financial statements and the auditor's report on the basic financial statements required by generally accepted auditing standards.

5.4 Bases of accounting other than generally accepted accounting principles are acceptable. The auditor should refer to the AICPA audit and accounting guides Audits of Colleges and Universities, Audits of Certain Nonprofit Organizations, Audits of Voluntary Health and Welfare Organizations, and Audits of Health Care Providers.

5.5 OMB 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. 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 fairly presented in accordance with GAAP, the auditor needs to consider whether noncompliance with any federal, state, or local laws would materially affect the statements. The auditor's responsibility for consideration of laws and regulations and their effect on the audit is described in SAS No. 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities; SAS No. 54, Illegal Acts by Clients; and SAS No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance. An illustrative report on basic financial statements in accordance with GAAP is presented in appendix D of this proposed SOP.

5.6 For an NPO to comply with Circular A-133, it is not necessary that its financial statements be presented in conformity with GAAP; it is sufficient if the auditor merely reports on such conformity in accordance with GAAS. For various reasons, such as convenience or the need to comply with legal or regulatory requirements, some NPOs prepare their financial statements on a basis of accounting other than GAAP (for example, the cash basis). When this is the case, the auditor's report should be prepared in accordance with SAS No. 62, Special Reports (AICPA, Professional Standards, vol. 1, AU sec. 623), which requires that it include a paragraph that (a) states the basis of presentation and refers to the note to the financial statements describing the basis and (b) states that the basis of presentation is a comprehensive basis of accounting other than GAAP.

#### The Auditor's Report on the Internal Control Structure

5.7 Both Government Auditing Standards and SAS No. 60 (AICPA, Professional Standards, vol. 1, AU sec. 325) 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 needs to complete the level of audit work outlined in SAS No. 55. The report does not express an opinion on an NPO's internal control structure, but rather describes the extent of work performed to comply with SAS No. 55. It should be noted that, beyond the issuance of an auditor's report on the structure, GAS requires no more work on the internal control structure than GAAS. The report presents the requirements of SAS No. 60 as well as the additional requirements of the Yellow Book to identify significant internal control structure categories and to describe the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk. The report should also describe deficiencies in the internal control structure considered to be 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-4 of this proposed SOP.

5.8 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

	<u>GAS</u>	<u>SAS No. 60</u>
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

5.9 Chapter 5 of Government Auditing Standards provides the following requirements for this report on internal controls. The third supplemental reporting standard is:

The auditors should prepare a written report on their understanding of the entity's internal control structure and the assessment of control risk made as part of a financial statement audit, or a financial related audit. This report may be included in either the auditor's report on the financial audit or a separate report. The auditor's report should include as a minimum: (1) the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing the control risk, (2) the entity'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 results of the financial related audit, 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.

## Identification of Controls

5.10 Depending on the circumstances, classifications or categories of controls identified as a part of an organization's system may include operating cycles, financial statement captions, accounting system applications, or other classifications appropriate for the particular circumstances on which the auditor is reporting.

5.11 Government Auditing Standards includes the following examples 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 and control  
Property and equipment  
General ledger

5.12 Although it may not be appropriate in all circumstances to include a description of the controls related to the general and specific requirements in the report, auditors reporting in accordance with Government Auditing Standards and OMB Circular A-133 need to consider including these controls. The decision whether to include that description should be based on whether noncompliance with a general or specific requirement could result in a material error in the financial statements.

5.13 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.

### Identification of Reportable Conditions

5.14 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.

5.15 Paragraph 17 of SAS No. 60 (AICPA, Professional Standards, vol. 1, AU sec. 325.17) prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. Footnote 1 of exhibit D-4 in appendix D of this proposed SOP illustrates a report that an auditor may issue to satisfy the requirements of Government Auditing Standards when no reportable conditions are noted during an audit.

### Nonreportable Conditions

5.16 If an auditor issues a separate written communication describing "nonreportable conditions," as discussed in paragraphs 35 and 36 of SAS No. 63 (AICPA, Professional Standards, vol. 1, AU secs. 801.35 to .36), the auditor's report on the internal control structure should refer to that separate communication in order to comply with Government Auditing Standards.

### The Auditor's Report on Compliance With Laws and Regulations

5.17 Government Auditing Standards requires auditors to report on compliance with laws and regulations that, if violated, could have a material impact on an entity's financial statements. Exhibit D-5 in appendix D of this proposed SOP illustrates the standard language for such a report. 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. For auditors to issue this report, identification and testing of laws and regulations, as outlined in SAS Nos. 53 and 54, are necessary. The second supplemental reporting standard in Government Auditing Standards follows:

The auditors should prepare a written report on their tests of compliance with applicable laws and regulations. This report, which may be included in either the report on the financial audit or a separate report, should contain a statement of positive assurance on those items which were tested for compliance and negative assurance on those items not tested. It should include all material instances of noncompliance, and all instances or indications of illegal acts which could result in criminal prosecution.

5.18 Positive assurance is expressed as a statement by the auditors that the tested items were in compliance with applicable laws and regulations. Negative assurance is conveyed in 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.

5.19 The auditor may need to omit the statement of negative assurance based on the results of his or her tests of compliance. For example, an auditor may find a systematic miscalculation of amounts due to participants in a federal assistance program who were selected for testing. Because the exception was systematic and would probably affect other untested participants, the auditor would not give negative assurance. Further, because only material noncompliance need be reported, the auditor's assertion of positive assurance would, if necessary, refer to the separate report of immaterial findings issued to the recipient organization.

#### Disclosure of Illegal Acts

5.20 Illegal acts are violations of laws or government regulations and may include such matters as falsification of records or reports and misappropriation of funds or other assets. SAS No. 54 (AICPA, Professional Standards, vol. 1, AU sec. 317) discusses the auditor's responsibilities with respect to illegal acts. Footnote 13 to paragraph 28 of SAS No. 63 (AICPA, Professional Standards, vol. 1, AU sec. 801.28) notes that an auditor following the requirements in SAS No. 54 will have complied with the requirements of Government Auditing Standards to consider the possibility of and to detect illegal acts. However, Government Auditing Standards has certain additional reporting requirements. Pages 5-4 and 5-5 of Government Auditing Standards indicate that the auditor is required to report instances or indications of illegal acts that could result in criminal prosecution. SAS No. 63 notes that in complying with this requirement, "the auditor may choose to report all illegal acts or possible illegal acts noted." Government Auditing Standards distinguishes the auditor's reporting responsibilities based upon whether the auditor is a government auditor or a public accountant.

5.21 Government Auditing Standards states that if a public accountant becomes aware of illegal acts or indications of such acts, prompt notice should be given to the top official of the entity arranging for the audit. In addition, the auditor should consider notifying the appropriate oversight body. If the top official is believed to be a party to such acts or is otherwise implicated, the auditor should report to an appropriate oversight body. If the acts involve funds received from government entities, the audited entity should report to the proper officials at the government entities. If the audited entity does not do so within a reasonable period of time or is unable to do so because the top official was involved, the auditor should report to the government audit officials.

5.22 Government Auditing Standards also states that if an external government auditor, or an internal government auditor auditing an entity external to his or her assigned organization, becomes aware of illegal acts or indications of such acts, the auditor should notify the top official of the organization. If the top official of that organization is implicated, the auditor should report to the appropriate oversight organization. If the acts involve federal funds passed through from another entity, the auditor should report to the appropriate officials of the entity providing the funds.

5.23 Government Auditing Standards further states that if an internal government auditor auditing his or her assigned government entity becomes aware of illegal acts or indications of such acts, he or she should notify the top official of that organization, "appropriate entity investigative personnel," or both.

5.24 Government Auditing Standards indicates that illegal acts or indications of such acts need not be included in the required audit reports, but they may be covered in a separate written report. Auditors should not release information, or reports containing information, regarding such acts or reports nor disclose that such acts were omitted from reports without consulting with appropriate legal counsel.

5.25 If the auditor's examination indicates the presence of errors or possible irregularities and the auditor remains uncertain about whether they will materially affect the financial statements, his or her opinion should be qualified or a disclaimer of opinion should be issued on the financial statements. 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. Before withdrawing from the engagement, the auditor should report the irregularity or illegal act to an appropriate level within the entity or the entity arranging for the audit, and to any other party to whom the auditor has a contractual obligation to report, for example, a federal cognizant audit agency or grantor agency.

5.26 Findings and Questioned Costs. Government Auditing Standards identifies as special terms audit findings and questioned costs. It describes 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.

5.27 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 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 27 of SAS No. 63 (AICPA, Professional Standards, vol. 1, AU sec. 801.27) notes that if the auditor has issued a separate letter describing immaterial instances of noncompliance, the compliance report should include a reference to that letter.

#### Audit Follow-up

5.28 The section entitled "Audit Follow-up" in chapter 3 of Government Auditing Standards adds:

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. . . .

5.29 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 sponsor's personnel. When corrective action has not been taken, the deficiency remains unresolved and could be material in the current audit period, the auditor need only 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 to that effect may be included in the audit report.

Views of Responsible Officials (Organization's Comments)

5.30 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.

5.31 The comments should include a statement by responsible officials of the audited organization regarding their agreement with the findings, conclusions, and recommendations as presented. If the organization does not agree and the auditor concludes that the findings, conclusions, and recommendations are valid, a rebuttal to the organization's comments addressing the reasons why he or she has not changed the findings, conclusions, and recommendations should be included in their report. The presentation of views is distinct from the organization's corrective action plan, which it submits directly to the sponsor or cognizant agency.

REPORTS REQUIRED BY OMB CIRCULAR A-133

5.32 SAS No. 63 and OMB Circular A-133 require that the auditor include the following reports on an organization's federal awards:

- o Reports required to be issued in an audit performed in accordance with Government Auditing Standards, as previously described
- o A report on a supplementary schedule of the entity's federal awards
- o A report on the internal control structure policies and procedures used in administering federal awards
- o A report on compliance with specific laws and regulations that may have a direct and material effect on each major program
- o A report on compliance with certain laws and regulations applicable to nonmajor programs
- o A report on compliance with general requirements

## Auditor's Report on the Supplementary Schedule of Federal Awards

5.33 The recipient or subrecipient of an award is responsible for preparing a schedule of federal awards. The schedule should identify major programs and show the total expenditures for each program. Individual major programs other than research and development and student financial aid should be listed, if practical, according to the appropriate CFDA catalog number. Expenditures for nonmajor programs should 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 or in related notes.

### Types of Assistance Programs and Payment Methods

5.34 There are over 1,000 individual grant programs and a number of distinct types of federal financial assistance payment methods. Many of these programs are described in the CFDA.

5.35 Currently, 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 to NPOs through the programs.

- o 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.
- o 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.
- o 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.
- o Direct Payments With Unrestricted Use. Financial assistance provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed regarding how the money is spent. Included are payments under retirement, pension, and compensation programs.

- o 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.
- o 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.
- o 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.
- o 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

5.36 Grant proceeds may be paid to NPOs directly or indirectly via reimbursement arrangements in which the recipient organization bills the grantor for costs as incurred. Some grant programs provide for advance payments. Other grant programs permit an organization to draw against letters of credit as grant expenditures are incurred. Certain grants have matching requirements in which the participating NPO must contribute a proportionate share of the total costs of a program.

5.37 Most federal financial assistance is in the form of cash awards. However, there are a number of federal programs that do not involve cash transactions with NPOs. These programs usually involve commodities, loan guarantees, loans, or insurance. The value of noncash assistance 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 would typically be shown 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. It should be noted that 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.

5.38 The individual sources of financial assistance may not be readily identifiable because of the commingling of assistance from various levels of government. When commingled assistance is identified, the requirements prescribed by each individual source should be considered. 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. When this occurs, the NPO may be responsible for complying with both federal and state requirements governing that

assistance. If it is believed that financial assistance could represent combined assistance from various levels of government, management should review contracts or other documents to determine the source of the assistance transaction. If the documentation indicates that assistance received from various sources may have been commingled, the subrecipient should ask the granting agency (a) whether the assistance provided includes assistance from another source, and (b) what are the source and amount of that additional assistance, if any, and the program through which that assistance was provided. If the commingled portion cannot be separated to specifically identify the individual funding sources, then the total amount should be included in the schedule with a footnote describing the commingled nature of the funds. A conservative approach to testing these commingled funds is to consider the total amount to be federal funds in order to determine the nature and extent of tests.

5.39 Once all sources of federal awards have been identified, assistance programs should be ranked in order according to the size of expenditure. Noncash assistance should be valued to complete the ranking process. The following table serves as a guide in valuing noncash assistance.

<u>Types of Noncash Assistance</u>	<u>Basis Used to Determine Major Programs</u>
Loans (except guaranteed student loan programs and loan guarantees)	Total value of new loans made during the year, plus the balance of loans for previous years for which the federal government is at risk, plus the 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 loan programs	Value of the guaranteed loans

5.40 Management should exercise caution when including noncash programs in determining major programs, since the size of these programs may result in the exclusion of other programs from the definition of major programs. If the number of programs determined to be major is significantly affected by the inclusion of a noncash assistance program in total federal assistance, the auditor should use his or her judgment to determine whether the program should be included when determining which other programs are major. In other words, the treatment of noncash programs should not affect the identification of major programs.

5.41 The OMB question-and-answer booklet for Circular A-128 audits qualifies its guidance for including noncash programs in the calculation of major programs as follows:

If based on the above, it is determined that a loan or loan guarantee program is a major program, this should not affect the identification of major programs, using the criteria applicable to the Schedule of Federal Assistance. Sometimes, including a large loan program in the base used to determine major programs may distort the base. Therefore, if the number of programs determined to be major is significantly affected by the inclusion of a guaranteed loan program in total federal assistance, the auditor should use his or her judgment as to which other programs are major.

The criteria applicable to the schedule of federal awards are described in paragraph 1.15 of this proposed SOP.

5.42 Once the ranking is complete, management should identify each major federal financial assistance program and the auditor should ascertain the reasonableness and completeness of management's determination.

5.43 In assessing the completeness of the schedule, 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 recipient governments when conducting an audit of a subrecipient.

5.44 The information that should be presented on the schedule includes--

- o 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 the CFDA number).
- o An identification of totals for student financial aid and research and development.
- o Other federal awards (those federal programs that have not been assigned a catalog number).
- o Total expenditures for each federal award program by grantor, department, or agency.
- o Total federal awards.

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

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

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

5.46 The financial information included in the schedule should be derived from the organization's books and records from which the general purpose or 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 schedule's data may not fully agree with the grant reports because, among other reasons, the grant reports--

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

5.47 Because the information is to 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 organization's financial statements. Although a reconciliation should be possible, it is not expected that the schedule's data will be directly agreeable or traceable to the entity's financial statements, because grant activity is usually not separately identifiable in the fund presentation used in the general-purpose or basic financial statements. The basis of accounting should be discussed in a footnote.

5.48 Subrecipients of federal awards should identify program funds that are received directly from the federal government and those received as pass-throughs from a not-for-profit or governmental unit. For those funds received from another recipient, the program's identifying number(s) from the CFDA should be included.

5.49 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 are presented, the auditor should discuss the form of presentation with the client personnel who are preparing it.

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

5.51 Other supplemental information may be provided by the auditor 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 financial status reports (FSRs), reconciliations of audited expenses to expenses reported on the FSRs, or other information that the auditor considers necessary for full disclosure of federal programs.

#### The Auditor's Report on the Internal Control Structure Used in Administering Federal Awards

5.52 OMB 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 identify--

- o If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements.
- o 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.
- o The organization'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.
- o The reportable conditions noted, including the identification of material weaknesses.

It should be noted that the requirements of this section of Circular A-133 go beyond the minimum requirements 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.

(See the example report in exhibit D-7 of this proposed SOP.)

#### Limitation on the Consideration of the Internal Control Structure

5.53 OMB Circular A-133 notes 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 considered to be a reportable condition. In addition, Circular A-133 notes 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

5.54 OMB Circular A-133 requires that the auditor report whether the organization has complied with laws and regulations that may have a direct and material effect on any of its major programs. The report on compliance with the specific compliance requirements applicable to major programs provides the auditor's opinion on whether the entity complied with the requirements that, if violated, could materially affect each major program. Examples in this proposed SOP illustrate various reports that can be issued based on the results of the compliance testing of specific requirements of major programs. An illustrative report when uncertainties about compliance exists is presented in exhibit D-12. The report describes the program requirements tested including any special tests and provisions. The special tests and provisions should be listed in the auditor's report individually, or alternatively, in an attachment to the opinion. They may also be listed in the footnotes to the schedule of federal awards. The report also makes reference to any immaterial instances of noncompliance with specific requirements that are included in the

schedule of findings and questioned costs. 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.

5.55 The Circular A-133 opinion is directed at "compliance, in all material respects," with the specific requirements set forth in the scope paragraph of the report. These requirements are those requirements of laws and regulations for which noncompliance could have a direct and material effect on each major program.

5.56 As noted above, specific requirements that have a material effect on a major program generally pertain to the types of services allowed or not allowed, eligibility, matching, reporting, cost principles, and special conditions.

#### Reporting on General Requirement Compliance

5.57 The auditor should issue a report on compliance with the general requirements regardless of whether the organization being audited has major programs. SAS No. 6X notes that determining the extent of any tests of compliance with the general requirements is a matter of professional judgment. SAS No. 6X does not require the auditor to issue an opinion on compliance with the general requirements; rather, the auditor issues a report on the results of procedures used to test compliance with the general requirements. SAS No. 6X specifies the basic elements of a report expressing positive and negative assurance on compliance with the general requirements, which is illustrated in exhibit D-14 of this proposed SOP. As noted in paragraph 5.19, the auditor may need to omit the statement of negative assurance based on the results of his or her tests of compliance.

#### Reporting on Nonmajor Program Compliance

5.58 OMB 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 for testing transactions from nonmajor programs in connection with the audit of the financial statements or the consideration of the internal control structure. 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 address 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 describing that situation is required.

#### Schedule of Findings

5.59 Circular A-133 requires that the auditor's report on compliance contain a summary of material findings of noncompliance and 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. Immaterial findings need not be disclosed in the report but should be reported in writing to the organization in a separate communication.

5.60 A questioned cost is defined in the Inspector General Act Amendments of 1988 as (a) an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds; (b) a finding that, at the time of the audit, such cost was not supported by adequate documentation; or (c) a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.

5.61 Findings of noncompliance are generally listed in a schedule that also identifies the dollar amount of questioned costs. Those costs are amounts not expended in compliance with the terms and conditions of the assistance agreements and regulations. According to OMB Circular A-133 and Government Auditing Standards, in reporting noncompliance, auditors should "place their findings in proper perspective." This perspective is both quantitative and qualitative. The extent of noncompliance should be related to the number and dollar amount of cases examined, the size of the population in 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 prevalence of noncompliance. The auditor's report on material noncompliance should contain a summary of all instances (findings) of noncompliance and identify total amounts questioned, if any, for each federal award. The use of a table may be appropriate to summarize extensive findings. It may also be appropriate to distinguish samples taken for different purposes (for example, attribute vs. variable samples).

5.62 In presenting the findings, the auditor may find it helpful to 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 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). However, the auditor may not be able to fully develop all of these points, given the scope and purpose of single audits. Findings may also include the pertinent views of responsible officials. 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.

5.63 Findings may also serve as a basis for a federal agency's conducting or contracting for additional audit work. (Appendix F of this proposed SOP includes illustrations of the reporting of noncompliance.) Government Auditing Standards and Circular A-133 require that the report disclose known, but uncorrected, significant material findings and recommendations included in prior reports.

#### Audit Follow-up (Status of Prior Audit Reports)

5.64 Section 2.1 of attachment F to OMB Circular A-110 provides that an organization have a systematic method to assure timely and appropriate

resolution of audit findings and recommendations. Paragraphs 5.28 and 5.29 of this proposed SOP describes the requirement for audit follow-up in Government Auditing Standards.

5.65 Federal agencies are required to track the status of management's actions on significant or material findings and recommendations from their prior audits. Upon completion of a desk or quality-control review of the working papers for an audit report prepared by an independent auditor, the appropriate agency provides the organization with a transmittal letter acknowledging the receipt of the audit report and indicates whether the report is acceptable in lieu of a federal audit. When the federal agency conducts its review, it may find an indication of a significant problem that was not disclosed in the auditor's report, and may add the finding(s) to the audit report by way of its transmittal letter. In such instances, the finding in the agency's transmittal letter becomes a part of the audit report and must be included in the auditor's comments on the status of prior audit findings and recommendations.

5.66 The management of some not-for-profit organizations advocates 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 identified noncompliance on the financial statements when preparing a report; FASB Statement No. 5 provides guidance in accounting for and reporting on such matters.

5.67 Some events of noncompliance do not have material financial implications, and disclosure of them on the financial statements, therefore, is not required. Nevertheless, special consideration should be given to those events for purposes of reporting to sponsors or donors and other purposes.

#### Combined Reporting

5.68 It may be feasible in some circumstances to combine the reports issued to comply with the reporting requirements of OMB Circular A-133. Thus, it may be possible to merge the several similar reports and thereby issue only three--financial, compliance, and internal control reports. However, many organizations and auditors may prefer to issue the reports separately, because the organization may not wish to include in its annual report a report that makes reference to special-purpose grant auditing and related compliance and internal control matters. Auditors should exercise care in combining such reports to assure that the unique reporting requirements of Circular A-133 are observed in the combined reports.

5.69 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, unless legal restrictions, ethical considerations, or other arrangements prevent such distribution.

5.70 Subrecipients should submit copies to recipients that provided federal awards. 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 a longer period is agreed to with the cognizant or oversight agency.

5.71 Recipients of more than \$100,000 in federal awards should submit one copy of the audit report within thirty days after issuance to a central clearinghouse to be designated by the Office of Management and Budget. The clearinghouse keeps completed audit reports on file.

5.72 The organization is required to provide the auditor's report on the general-purpose or basic financial statements, and the auditor's internal control and compliance reports to the cognizant or other oversight agency that provides the majority of federal awards. While the various auditor's reports may have different dates and may be received by the organization at different times, they should be delivered together to the cognizant or other oversight agency. In addition, the organization must submit a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings to the cognizant or oversight agency or funding organization.

5.73 Although the required reports may be issued simultaneously to the recipient, it may not be practicable to do so, and the auditor should consider this when planning the audit.

#### Freedom of Information Act

5.74 In accordance with the principles of the Freedom of Information Act (Public Law 90-23), 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, or other personal identification in either the body of the report or any attached schedules.

## CHAPTER 6

### SPECIAL AUDIT CONSIDERATIONS OF OMB CIRCULAR A-133

#### PLANNING CONSIDERATIONS

6.1 The scope of the organization-wide audit specified by OMB Circular A-133 was introduced in chapter 2 of this proposed SOP. In planning such audits, auditors should determine the nature, timing, and extent of work to be performed and prepare written audit programs. Circular A-133 and GAS establish audit requirements to satisfy the needs of federal program managers and other users of the financial statements and reports for federal financial assistance programs.

6.2 In planning an audit in accordance with Circular A-133, the auditor considers several matters in addition to those ordinarily considered in an audit of financial statements in accordance with generally accepted auditing standards. This chapter discusses overall planning considerations in an organization-wide audit.

#### OVERALL ORGANIZATION-WIDE AUDIT-PLANNING CONSIDERATIONS

6.3 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--

- o Materiality.
- o The cognizant agency.
- o Government Auditing Standards, including continuing education and quality-control requirements.
- o Subrecipients.
- o Initial-year audit considerations.
- o Reliance on other auditors.
- o Joint-audit considerations.
- o Quality-assessment programs.
- o The engagement letter.
- o Higher-level audit services.
- o The exit conference.

## Materiality

6.4 Materiality is a significant matter that should be considered in planning the organization-wide audit. SAS No. 47 (AICPA, Professional Standards, vol. 1, AU sec. 312) provides guidance on the auditor's consideration of materiality when planning and performing an audit of financial statements in accordance with GAAS.

6.5 In auditing compliance with 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 entity's financial statements, materiality is considered in relation to the financial statements being audited. In an audit of an entity's compliance with requirements governing major programs in accordance with Circular A-133, however, materiality is considered in relation to each major program.

6.6 Because the auditor expresses an opinion on each major program and not on all of 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 should require consideration of the type and nature of the noncompliance as well as the actual and projected impact on each major program under audit. Instances of noncompliance that are material to a major program may not be material to a major program of a different size or nature. Additionally, the level of materiality relative to a particular major program can change from one period to another.

## Relationships With the Cognizant Agency

6.7 For some organizations subject to OMB Circular A-133, the OMB has assigned a cognizant agency. 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 circular.

6.8 Auditors should, where warranted and practicable, communicate with the cognizant agency before, during, and after the audit to avoid or minimize disagreements or other problems. The auditor may desire to discuss with the cognizant agency, through the recipient organization, such matters as the audit plan, the scope of compliance testing of programs for specific requirements, and the intended use of the entity's financial statements.

6.9 If the cognizant agency disagrees with significant elements of the audit plan, these matters should be resolved among the recipient, the cognizant agency (or major funder), and the auditor before field work commences.

## Responsibilities of the Cognizant Agency

6.10 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 funds, either directly or indirectly.

6.11 Circular A-133 states that a cognizant agency has the following responsibilities:

- 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. Seek the views of other interested agencies before completing a coordinated audit.

6.12 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.

6.13 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. In some cases, one federal department or agency may assume the oversight responsibility for a single class of NPOs even though they do not provide the most funds to every organization in that class.

## Government Auditing Standards

6.14 OMB Circular A-133 requires that the audit be performed by an independent auditor in accordance with Government Auditing Standards. Two of the most significant Government Auditing Standards requirements are those affecting continuing professional education and peer-review requirements.

6.15 Continuing Professional Education Requirements. Government Auditing Standards requires auditors to participate in a program of continuing education and training. Every two years, certain auditors performing audits in accordance with GAS should complete at least eighty credit hours 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 government environment and governmental auditing. (If the auditor performs audits of an entity that operates in a specific or unique environment, such as the not-for-profit environment, the twenty-four hours should be in topics related to the not-for-profit accounting and auditing environment.) A detailed interpretation of the CPE standards, Interpretation of Continuing Education and Training Requirements (stock number 020-000-00250-6), is available from the Government Printing Office. During engagement planning, auditors and audit organizations should ensure that appropriate members of the audit team have met the CPE requirement.

6.16 Peer Review. 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 once every three years. The first review should be completed on or before December 31, 1991. If the audit organization has only a small number of audits under Government Auditing Standards, this requirement can be met by a quality review of specific audits in a three-year period, rather than a review of the audit organizations' internal quality-control policies and procedures.

## Subrecipient Considerations

6.17 Many NPOs and governmental units make subcontract or subgrant awards and disburse their own as well as federal funds to subrecipients. In many instances, the amount of these payments or provisions of goods to the subrecipients is material to the primary recipient's financial statements. Examples of a typical recipient-subrecipient relationship include the following:

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

6.18 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."

6.19 A subrecipient is distinguished from a vendor by the degree of responsibility assumed to help the recipient meet the requirements of the assistance award. A vendor's responsibility is to meet the requirements of a procurement contract for goods or services; the other party to the contract is generally not a subrecipient for purposes of the organization-wide audit. In the absence of a procurement contract or similar agreement, the party initially should be considered a subrecipient. A subrecipient relationship does not exist if a contract for units of service exists and the vendor does not participate in meeting the requirements of the assistance award. Typical of this buyer-vendor relationship is the purchase of medical services, vocational training services, or a participating government's purchase of supplies or equipment through a regional pooled purchasing program, which was funded in part by federal assistance.

6.20 Federal awards normally are redistributed to subrecipients only on the basis of properly completed and approved awards. These written agreements include requirements that subrecipients comply with federal conditions set by the initial federal agency and any additional requirements established by the pass-through agency.

6.21 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. Further, Circular A-133 provides that in such instances, the primary recipient should--

- o Determine whether subrecipients and, if applicable, governmental subrecipients covered by Circular A-128 have met the audit requirements of Circulars A-133 and A-128, respectively.
- o Determine whether the subrecipient spent federal funds provided in accordance with applicable laws and regulations.
- o Ensure that appropriate corrective action is taken within six months after receipt of the subrecipient audit report on reported instances of noncompliance with federal laws and regulations.
- o Consider whether subrecipient audits necessitate adjustment of the recipient's own records.
- o Require each subrecipient to permit independent auditors to have access to their records and financial statements as necessary to comply with Circular A-133.

6.22 Those responsibilities may be discharged by relying on independent audits performed for the subrecipients, 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.

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

6.24 In establishing its system for monitoring subrecipients, management should design procedures sufficient to detect a subrecipient's material noncompliance with applicable federal rules and regulations. Financial operations of subrecipients related to the federal awards may be subjected to timely and periodic audits. If not, management should develop alternative procedures for monitoring their subrecipients. Management may perform procedures such as the following to monitor their subrecipients:

- o Review submitted reports and evaluate for completeness and for compliance with applicable laws and regulations. If considered necessary, review the working papers of the auditors. Subrecipients receiving less than \$25,000 are not required to be audited.
- o Evaluate audit findings and determine if a plan for corrective action has been prepared and implemented.
- o Review grant applications submitted by subrecipients to determine the following:
  - Applications are approved by management before any funds are awarded.
  - Applications are filed in a timely manner.
  - Applications contain the condition that the subrecipient comply with the federal requirements set by the initial federal agency.
- o Determine that funds are disbursed to subrecipients only on an as-needed basis.
- o Determine that disbursements to subrecipients are approved and are based on properly completed reports submitted on a timely basis.
- o Ascertain that refunds due from subrecipients are billed and collected in a timely manner.
- o Determine that procedures exist to ensure that subrecipients and those using the funds meet all eligibility requirements.
- o Determine that reports received from subrecipients are reviewed on a timely basis and that all unusual items are fully investigated.

- o Review evidence of previously detected deficiencies and determine that corrective action was taken.

6.25 The auditor of the primary recipient should develop an understanding of the design of the NPO's system for monitoring subrecipients and determine whether the system has been placed in service. The auditor should also assess the level of control risk by evaluating the effectiveness of the NPO's monitoring system in preventing or detecting subrecipients' noncompliance with the applicable rules and regulations. To evaluate the effectiveness of the monitoring system, the auditor should perform tests of controls. These tests may include reperformance of some or all of the procedures identified previously as management's responsibilities.

6.26 The nature and extent of the tests performed vary depending on the auditor's assessment of control risk and professional judgment. Generally, the auditor's work is limited to those subrecipients that receive over \$25,000 during the year.

6.27 The specific exceptions reported in a subrecipient's audit report are not required to be included in the primary recipient's audit report. However, the auditor should consider the effects of reported exceptions, events, or indications of material weaknesses in the primary recipient's monitoring system that could have a material effect on the related major program.

6.28 If subrecipient audits have not been made and the grant awards are material to 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. The purpose of expanding the scope of the audit of the recipient to include the records of subrecipients is to test 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 subgrant as a questioned cost and modifying the auditor's report on compliance with laws and regulations. Additionally, deficiencies in the internal control structure may exist.

#### Additional Responsibilities of the Auditor

6.29 The auditor may have responsibilities in addition to those set forth in Government Auditing Standards and OMB Circular A-133. The auditor should determine if such additional responsibilities exist through discussions with the client. SAS No. 63 (AICPA, Professional Standards, vol. 1, AU secs. 801.89 through 91) provides guidance on assuring that auditors and management understand the type of engagement to be performed.

6.30 To become familiar with any additional requirements of sponsors, the auditor of a not-for-profit organization should consider performing preliminary procedures such as the following:

- o Identify sources of revenue received by the organization and inquire 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.

- o Identify compliance requirements. The audit divisions of sponsoring agencies or foundations usually can be helpful in identifying these requirements, which may be identified separately for each recipient or published in an audit guide.
- o In performing an organization-wide audit of sponsored programs, consider the major compliance features of larger federal grant programs. As described subsequently, the OMB has published the major compliance features of larger federal grant programs.
- o Consider state and local governmental requirements.

#### Determination of the Audit Period

6.31 An audit in accordance with OMB Circular A-133 should cover the reporting entity's financial transactions for its fiscal year, 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 an assistance program because a portion of a program's transactions might not fall within the period covered by the audit. 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.

#### Initial-Year Audit Considerations

6.32 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 (AICPA, Professional Standards, vol. 1, AU sec. 315). 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 special work is not required, testing for the prior unaudited period would be limited to balances as of the end of that unaudited period.

6.33 In auditing an NPO's compliance with the terms of its awards as required by Circular A-133, the auditor selects and tests a sample of transactions that is valid for each of the major programs rather than for the financial statements taken as a whole. This means that testing increases significantly from that required for an audit of financial statements. Chapter 4 of this proposed SOP describes factors that the auditor considers in the selection and compliance testing of transactions.

#### Reliance on Other Auditors

6.34 When an organization-wide audit is conducted, there may be instances when it will be necessary to refer to the work of other auditors in a principal auditor's report (see paragraph 2.16 of this proposed SOP, which discusses the coordinated audit). There may be instances when the audit may

be performed by more than one auditor, such as prime-subcontractor arrangements.

6.35 In order to comply with Circular A-133's provisions with regard to small and minority firms, certain NPOs may require that their audits be performed on a joint-venture or subcontract basis with small, minority, or socially or economically disadvantaged independent accounting firms.

6.36 Prior to entering an agreement to perform an audit or subcontract with another firm, the auditor should review SAS No. 1 (AICPA, Professional Standards, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors") and AICPA Ethics Interpretation 101-10.

6.37 At a minimum, the principal auditor should perform the following:

- o Ensure his or her own independence of the oversight entity and reporting organization.
- o Obtain separate audited financial statements of each component unit or federal program included.
- o 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 from federal agencies to the entity received after the audit date.

6.38 If the organization-wide audit is performed by governmental auditors,<sup>1</sup> the auditors should be satisfied that the government auditors meet the independence standards in chapter 3 of Government Auditing Standards. 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.

6.39 Another common occurrence is the conducting of a separate financial and compliance audit 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. When conducting a coordinated audit, auditors are required to issue reports on the compliance and internal control structure. Typically, the auditor of the oversight entity will not have performed the procedures necessary to issue the required reports on compliance and internal control relative to the component unit. Therefore, the required reports on compliance and internal control of the oversight entity should contain appropriate disclaimer language when the principal auditor has not performed the required procedures.

#### Joint Audit Considerations

6.40 In some circumstances each of the independent auditors participating in the organization-wide audit will have signed the report in their individual capacities. Each individual or firm signing the audit report should be

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<sup>1</sup> See paragraphs 2.15 through 2.20 of this proposed SOP, which describe the coordinated audit.

considered to separately express an opinion on the financial statements. Signing the report in an individual capacity is appropriate only if the individual or firm has complied with GAAS and is in a position that would justify being the only signatory of the report.

#### Quality-Assessment Programs

6.41 In addition to the quality-control requirements set forth in Government Auditing Standards, cognizant agencies have implemented procedures for evaluating audits. As a part of the cognizant agencies' evaluation of completed reports of such engagements, the supporting audit workpapers must be made available upon request of the regional inspector general. Audit workpapers are reviewed at a location mutually agreed upon with the independent auditor and are returned upon completion of the evaluation. SAS No. 41, Working Papers (AICPA, Professional Standards, vol. 1, AU sec. 339), discusses certain matters related to the ownership and custody of working papers. SAS No. 41 states that "[w]orking papers are the property of the auditor, and some states have statutes that designate the auditor as the owner of the working papers."

6.42 Whenever an evaluation of the audit report or the working papers discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are not corrected and the representative of the local cognizant agency determines that the audit report and the working papers are below standard, all documentation is forwarded to the cognizant agency for further evaluation and action, if appropriate. In those instances when 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

6.43 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. Appendix G of this proposed SOP presents an example engagement letter. Auditors should consider describing items such as the following:

- o The requirements of Government Auditing Standards
- o The additional reports required by OMB Circular A-133
- o 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)

6.44 In addition to sending an engagement letter, a good practice for the auditor to follow is to document the planning process and circulate the results to the interested parties so that there is a clear understanding of the intended scope of the audit, the major programs to be audited, and the handling of the other areas listed in this chapter. Through gaining the concurrence of the cognizant agency, auditor, and auditee, questions and misunderstandings during and after the audit can be avoided.

## HIGHER LEVEL AUDIT SERVICES

6.45 Footnote 4 to paragraph 1.7 of this proposed 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 3 and 4 of SAS No. 6X). Circumstances that may indicate higher-level audit requirements include--

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

## EXIT CONFERENCE

6.46 Upon completion of the field work, the auditor should hold a closing or exit conference with senior officials of the organization. In the case of decentralized operations, 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. Any audit findings and recommendations, either of a financial, compliance, or internal control nature, should be discussed fully.

6.47 The exit conference gives the auditor an opportunity to obtain management's comments on the accuracy and completeness of the facts he or she presents and the conclusions he or she has reached. 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."

6.48 The audit working papers should identify 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.

APPENDIX A

OMB CIRCULAR NO. 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 sub-recipient 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 Aid.
- 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 Aid" 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 noncompliance 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 15 c(2) of this Circular.
  - (b) Review the recipient's system for monitoring sub-recipients 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 non-major 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 Catalog of Federal Domestic Assistance (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 Federal Acquisition Regulations); 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 Single Audits of Educational Institutions and Other Nonprofit Organizations," 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 evaluations 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 non-cash 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:
    - o The size of the universe in number of items and dollars,
    - o The number and dollar amount of transactions tested by the auditors,
    - o 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, 1211 Avenue of the Americas, New York, New York 10036-8775 (1-800-334-6961; in NY, 1-800-248-0445). Federal Government publications may be obtained from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402 (order desk telephone: 202-783-3238). Standards of the President's Council on Integrity and Efficiency (PCIE) can be obtained by writing or faxing the Treasury Office of Inspector General, Room 7210, ICC Building, 1201 Constitution Avenue, NW, Washington, D.C. 20220 (fax: 202-535-4867), or by calling 202-732-4798.

#### 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, Cost Principles for Hospitals

#### AUDITING STANDARDS

- a. AICPA Professional Standards, volume I, including SAS No. 63, 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

- a. Audits of Certain Nonprofit Organizations, which includes SOP 78-10, Accounting Principles and Reporting Practices for Certain Non-profit Organizations

- b. Audits of Voluntary Health and Welfare Organizations (second edition)
- 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 (1986 revised edition)
- h. SOP 89-6, Auditor's Reports in Audits of State and Local Governmental Units
- i. SOP 90-9, The Auditor's Consideration of Internal Controls Used in Administering Federal Financial Assistance Programs Under the Single Audit Act

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 Single Audits of Educational Institutions and Other Nonprofit Organizations (forthcoming)
- 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
- 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-100 (cost sharing)
- i. OMB Circular A-110, Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Nonprofit Organizations
- j. OMB Circular A-122, Cost Principles for Nonprofit Organizations
- k. OMB Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions

## PCIE STATEMENTS

- 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% 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.

## SPONSORS' GUIDELINES, SUCH AS THE FOLLOWING:

- o Financial Aid Handbook, issued by the Department of Education
- o The National Science Foundation's Grants for Scientific Research
- o Federal Acquisition Regulations (FAR)
- o Defense Department Supplement (DFARS)
- o United Way
- o 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.



## 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:

- o Obtain any applicable audit guidance from the grantor agency.
- o Confirm with the grantor agency that any audit guides expected to be used contain all administrative rulings and amendments pertaining to the grant.
- o 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 chart indicates the reports illustrated in this appendix for various engagements.

<u>Engagement</u>	<u>Reports</u>
Report on basic financial statements	D-1
Report on supplementary information-- schedule of federal awards	D-2
Report on basic financial statements presented with a schedule of federal awards reported as supplementary data	D-3
Reports in accordance with <u>Government Auditing Standards:</u>	
Internal control structure	D-4
Compliance	D-5
Compliance--uncertainty	D-6
Reports in accordance with the Single Audit Act:	
Internal control used in administering federal awards	D-7
Major programs:	
Specific requirements:	
Unqualified opinion	D-8
Qualified opinions:	
Scope limitation	D-9
Noncompliance	D-10
Adverse opinion	D-11
Uncertainty	D-12
Disclaimer	D-13
General requirements	D-14
Nonmajor programs	D-15
Report combining reports D-8, D-14, and D-15	D-16

Independent Auditor's Report on Basic Financial Statements[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] 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. 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.

[Signature][Date]

Independent Auditor's Report on Supplementary Information--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] for the year then ended and have expressed our unqualified opinion on these financial statements, dated August 15, 19XX. 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 with 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.

Our audit was made for the purpose of forming an opinion on the 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 in accordance with the requirements of Office of Management and Budget Circular A-133, and is not a required part of the financial statements. The information in this schedule has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements taken as a whole.

[Signature]

[Date]

Independent Auditor's Report on Basic Financial Statements Presented  
With a Schedule of Federal Awards Reported as Supplementary Data

[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] 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. These 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 years then ended, in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the 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 in accordance with the requirements of Office of Management and Budget Circular A-133, and is not a required part of the financial statements. The information in this schedule has been subjected to the procedures applied in the audit of the financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements taken as a whole.

[Signature]

[Date]

Report on the Internal Control Structure in Accordance  
With Government Auditing Standards

[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.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. These 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 general-purpose 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. To fulfill 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 according to the following categories: [identify internal control structure categories].

For all of the control 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.<sup>1</sup>

[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 reported to the management of [name of organization] in a separate communication dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

Notes:

1. 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 sixth 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 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. We noted no matters involving the internal control structure and its operation 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 communication dated August 15, 19XX.

[The last paragraph of the report is the same as that illustrated above.]



Compliance Report Based on an Audit of General-Purpose  
or Basic Financial Statements Performed in Accordance  
With Government Auditing Standards

[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.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. These 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.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

Compliance Report Based on an Audit of General-Purpose or Basic Financial  
Statements Performed in Accordance With Government Auditing Standards  
When Uncertainty About Compliance 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.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. These 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 these failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following instances of noncompliance that may be material to the financial statements, but the ultimate resolution for any liability resulting from which has been recognized in the [name of organization]'s 19XX financial statements.<sup>1</sup>

[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 these provisions.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

Notes:

1. If, as a result of tests of compliance with laws and regulations, an instance of noncompliance is noted and this compliance report is modified, the impact of the instance of noncompliance would be considered when reporting on the financial statements, and, if necessary, an explanatory paragraph similar to the following would 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 federal financial assistance requirements for programs that may be material to the financial statements. The financial statements do not include an adjustment for any liability that may result from the actions of federal agencies relative to these instances of noncompliance.

Auditors should be aware that certain instances of noncompliance, either individually or in the aggregate, may be material enough to warrant a disclaimer of opinion on the financial statements.

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. We have also audited [name of organization]'s compliance with requirements applicable to major federal award 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 Nonprofit 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 award program.

In planning and performing our audits 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 opinions on the financial statements and on its compliance with requirements applicable to major programs, and not to provide assurance on the internal control structure. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal financial award 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 award 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 awards in the following categories: [identify internal control structure categories].<sup>1</sup> For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.

During the year ended June 30, 19XX, [name of organization] expended X percent of its total federal awards under major programs.<sup>2,3</sup>

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. 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 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 judgement, could adversely affect the organization's ability to administer federal award programs in accordance with applicable laws and regulations.

[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 noncompliance with laws and regulations that would be material to a federal award 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.<sup>4</sup>

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 communication dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This is not

intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

Notes:

1. Following are examples of different ways in which internal control structure policies and procedures used in administering federal award programs might be classified. The auditor should modify these examples or use other classifications, as appropriate, for the particular circumstances on which the auditor is reporting. However, there is no need to present in detail internal control structure policies and procedures, even though test work may be performed at that level.

General requirements

- o Political activity
- o Davis-Bacon Act
- o Civil rights
- o Cash management
- o Relocation assistance and real property management
- o Federal financial reports
- o Allowable costs/cost principles
- o Drug-free workplace
- o Administrative requirements

Specific requirements

- o Types of services
- o Eligibility
- o Matching, level of effort, or earmarking
- o Reporting
- o Cost allocation
- o Special requirements, if any
- o Monitoring subrecipients

Claims for advances and reimbursements

Amounts claimed or used for matching

2. If a cyclical approach is used, the sixth paragraph of this report should be modified, and a paragraph that clearly describes the coverage provided for nonmajor programs should be added after the sixth paragraph, as follows:

Because of the large number of nonmajor programs and the decentralized administration of these programs, we performed procedures on a cyclical basis to obtain an understanding of the internal control structure policies and procedures relevant to nonmajor programs. Our procedures during the current year covered X percent of the nonmajor programs administered by the organization as a whole. The nonmajor

programs 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.

3. If the total awards expended under major programs is less than 50 percent of total federal awards expended by the recipient organization during the year under audit, the auditor should follow the guidance in paragraph 3.17 of this statement of position to satisfy the objectives of Circular A-133. When such guidance is followed, the seventh and eighth paragraphs of the report on the internal control structure used to administer federal awards 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.

If the recipient organization had no major programs during the year under audit, the auditor should follow the guidance in this statement to satisfy the objectives of OMB Circular A-133. When such guidance is followed, the sixth and seventh paragraphs of the auditor's report on the internal control structure 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.

Also, the report would omit references to an audit of compliance with requirements applicable to major programs.

4. 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 compliance with requirements applicable to major federal awards 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] and of its compliance with requirements applicable to its major programs for the year ended June 30, 19XX, and this report does not affect our reports thereon dated August 15, 19XX. [A description of the material weaknesses that have come to the auditor's attention would follow.]



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.

We have also audited [name of organization]'s compliance with the requirements governing [list requirements tested] that are applicable to each of its major 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 the [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.

In our opinion, [name of organization] complied, in all material respects, with the requirements governing [list requirements tested] that are applicable to its major programs, which are identified in the accompanying schedule of federal awards, 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]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

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-8.]

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 major program ABC governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to [name of organization]'s compliance with those requirements of major program ABC by performing other auditing procedures. ABC program's expenditures totaled \$XX.

[The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in exhibit D-8.]

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 major program ABC governing the 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 its major programs, which are identified in the accompanying schedule of federal awards, 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]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

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-8.]

The results of our audit procedures for major program ABC disclosed that [name of organization] did not comply with the requirement that [name of organization] match the funds received from major program ABC. In our opinion, [name of organization]'s matching of funds received from major program ABC is necessary for [name of organization] to comply with the requirements applicable to major program ABC.

[The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in exhibit D-8.]

In our opinion, except for those instances of noncompliance with the requirements applicable to major program ABC 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], which are applicable to 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]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

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-8.]

[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-8.]

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 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]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

Opinion on Compliance With Specific Requirements Applicable  
to Major Programs Involving Uncertainties<sup>1</sup>

[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.

We have also audited [name of organization]'s compliance with requirements governing [list requirements tested] that are applicable to each of its major programs, which are identified in the accompanying schedule of federal awards,<sup>2</sup> 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 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 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 for major program ABC disclosed that [name of organization] did not comply with the requirements that the organization match the funds received from major program ABC. In our opinion, the organization's matching of funds received from major program ABC is necessary for the organization to comply with the requirements applicable to major program ABC.

The results of our audit procedures also disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs.<sup>3</sup> 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 the requirements applicable to major program ABC 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.

Resolving instances of noncompliance identified in paragraphs three and four of this report is the responsibility of the federal grantor agencies. The determination of whether the identified instances of noncompliance will ultimately result in a disallowance of costs cannot presently be 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.

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.

[Signature]

[Date]

Notes:

1. This report would be issued to satisfy the Circular A-133 requirement to report on specific compliance requirements of major programs when an uncertainty exists with respect to compliance with laws and regulations of a major program.
2. Major programs need to be clearly identified in the schedule of federal awards.
3. If there are no instances of noncompliance relating to major programs noted, this paragraph should be deleted.

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 of the standard report on major program compliance illustrated in exhibit D-8.]

We were engaged to audit [name of organization]'s compliance with the requirements governing [list requirements tested] that are applicable to each of its major 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 third paragraph of the standard report on major program compliance, illustrated in exhibit D-8, should be omitted.]

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 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]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

Report on Compliance With the General Requirements

[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.

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].

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's Compliance Supplement for Single Audits of State and Local Governments [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 those 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.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]



Report on Compliance With 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.

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 awards, as required by Office of Management and Budget Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions, we selected certain transactions applicable to certain nonmajor programs for the year ended June 30, 19XX. As required by OMB Circular A-133, we have performed procedures to test compliance with the requirements governing [list requirements tested] 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 those procedures disclosed no material instance 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. 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.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

Combined Compliance Report on Major Programs,  
Nonmajor Programs, and General Requirements<sup>1</sup>

[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.

We have also audited the [name of organization]'s compliance with the requirements governing [list requirements tested] that are applicable to each of its major 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. 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.

In our opinion, [name of organization] complied, in all material respects, with the requirements governing [list requirements tested] that are applicable to its major programs, which are identified in the accompanying schedule of federal awards, for the year ended June 30, 19XX.

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 awards, as required by OMB Circular A-133, we selected certain transactions applicable to certain nonmajor programs for the year ended June 30, 19XX. As required by OMB Circular A-133, we have performed procedures to test compliance with the requirements governing [list requirements tested] that are applicable to those transactions. Also, 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.]

Our procedures for testing compliance with the general requirements described in the previous paragraph were limited to the applicable procedures described in the Office of Management and Budget's Compliance Supplement for Single Audits of State and Local Governments [or describe alternative procedures performed]. Our procedures for testing compliance with the general requirements and the requirements applicable to the nonmajor programs, which are described in the previous paragraph, 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 those procedures disclosed no material instances of noncompliance with the requirements listed in the sixth 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.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. This is not intended to limit the distribution of this report, which is a matter of public record.

[Signature]

[Date]

**Note:**

1. This example combines the reports illustrated in exhibits D-8, D-14, and D-15.

APPENDIX E

EXAMPLE NOT-FOR-PROFIT-ORGANIZATION SCHEDULE OF FEDERAL AWARDS  
FOR THE YEAR ENDED JUNE 30, 19XX<sup>1</sup>

Federal Grantor/Pass-Through Grantor/ Program Title <sup>2</sup>	Pass-Through CFDA Number <sup>3</sup>	Grantor's Number	Disbursements/ Expenditures
<b>MAJOR PROGRAMS</b>			
U. S. Department of Education direct programs:			
Impact aid	84.041	N/A	\$X,XXX,XXX
Bilingual education	84.003	N/A	X,XXX,XXX
Passed through state department of education:			
Chapter 1	84.011	XXXXX	X,XXX,XXX
Chapter 2	84.051	XXXXX	X,XXX,XXX
Vocational education--basic grants to states	84.048	XXXXX	X,XXX,XXX
X,XXX,XXX			X,XXX,XXX
<b>TOTAL DEPARTMENT OF EDUCATION</b>			
U. S. Department of Housing and Urban development direct programs			
Community development block entitlement	14.218	N/A	X,XXX,XXX
Urban development action grant	14.221	N/A	0
X,XXX,XXX			X,XXX,XXX
Passed through state department of community development:			
Commercial development block grant--state's program	14.219	XXXXX	X,XXX,XXX
<b>TOTAL U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT</b>			
<b>OTHER FEDERAL AWARDS<sup>4</sup></b>			
<b>TOTAL FEDERAL AWARDS</b>			
			\$X,XXX,XXX

<sup>1</sup> This schedule may be expanded to show NFP identifying numbers, matching contributions, and other information. The schedule may also show information by individual grant, with columns added for grant number and grant period.

<sup>2</sup> All major and nonmajor programs should be individually identified, including those completed or terminated during the audit period.

<sup>3</sup> Catalog of Federal Domestic Assistance number.

<sup>4</sup> For significant programs or grants that have not been assigned a CFDA number, these programs or grants should be identified separately.

## APPENDIX F

### SAMPLE SCHEDULES OF FINDINGS AND QUESTIONED COSTS

#### EXAMPLE I: SERVICING OF GUARANTEED STUDENT LOANS

##### Servicing Agreement: Section 1--Due-Diligence Procedures

##### Sample Procedures:

We observed, on a test basis, that delinquency letters and notices were being sent out on a timely basis, as prescribed by federal regulation, by selecting 140 borrowers from the various aging pools from the April 30, 19XX, delinquency report, and by examining the letters sent on June 3 that notified borrowers of their status or obtaining a specific explanation that documented the reason why no letter was sent, as appropriate.

##### Our Findings:

XYZ failed to complete the procedures required to satisfy the due-diligence requirements within the stated period of time for one of the 140 borrowers included in our sample. The violation occurred because XYZ neglected to make the second attempt to reach the borrower by phone by the measurement date required within the 90- to 120-day aging pool, and the call was not made within the six-day grace period. It should be noted that federal regulations indicate that one due-diligence violation of less than forty-six days does not result in the loss of the guarantee on the loan, but may result in a loss of the subsidy and the special allowance after the date of default. In our view, the potential loss of special allowances payments in one case out of 140 is not significant.

In addition, XYZ failed to perform timely due-diligence procedures for five other borrowers of the 140 tested. The violations of due diligence in all five cases also resulted from XYZ's failure to complete the required attempts to reach the borrowers by phone a second time within the time periods stated in the federal regulations. It should be noted that in each of the five cases, XYZ performed the due-diligence procedures within the six-day grace period allowed in the March 20, 19XX, letter to Guarantee Agency Directors from the Assistant Secretary for Postsecondary Education and the Deputy Assistant Secretary for Student Financial Assistance. Because the calls were made within the "grace" period, there is no financial effect.

##### Management Response:

It should be noted that for the period after April 30, 19XX, XYZ has instituted the following procedures and goals to ensure that collection calls are completed in a timely manner:

- All collection calls for a given aging pool are to be completed in the first sixteen days of the thirty-day period or fourteen days before the end of the period.

- To monitor the results, a daily report is prepared for the manager, indicating the affected accounts listed by the number of days they have been delinquent. The manager can then direct XYZ personnel to contact all accounts within the first sixteen days of the time period.
- A nightly summary report is to be given to management identifying any exceptions to the fourteen-day grace period.

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EXAMPLE II: INTERNATIONAL DEVELOPMENT AGENCY

Timely Submission of Financial and Programmatic Reports:

As in the prior report, we noted that there were delinquencies in the submission of financial and programmatic reports on AID grants, although the situation has improved markedly:

<u>Type of Report</u>	<u>Reports Selected for Testing</u>		<u>Reports Not Timely Submitted</u>	
	<u>19X1</u>	<u>19X0</u>	<u>19X1</u>	<u>19X0</u>
Programmatic	58	54	8	5
Financial	92	82	19	45
Trip	15	20	10	19

We continue to recommend that the organization submit these reports earlier and that one person on the organization staff be responsible for ensuring the timely submission of the reports.

Management Response:

We believe that the corrective action taken was sufficient to achieve compliance; however, turnover of responsible staff has caused some relaxation of control. We have also implemented a travel-authorization process which requires the filing of a trip report prior to obtaining authorization to travel on another trip.

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. As shown in the table below, the organization manages the advances so that additional interest will not be significant, even if all funds were invested in interest-bearing accounts.

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:

	<u>Domestic Accounts</u>		<u>Foreign Accounts</u>	
	<u>19X1</u>	<u>19X0</u>	<u>19X1</u>	<u>19X0</u>
Drawdowns selected for testing	\$1,858,588	\$2,922,966	\$645,758	\$675,667
Drawdowns not fully expended within time guidelines	18%	21%	5%	3%

For the domestic accounts, we noted that 82 percent and 79 percent of the funds drawn in 19X1 and 19XX, respectively, were disbursed within three days.

We recommend that all funds held overseas be placed in interest-bearing accounts in accordance with AID directives.

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: COLLEGE OR UNIVERSITY

Student Financial Assistance Programs--Findings and Questioned Costs

<u>Program</u>	<u>Finding/Noncompliance</u>	<u>Questioned Costs</u>	<u>Comments</u>
Student financial aid programs	Our testing of all financial aid recipients for possible overawards showed that 3 students have received aid in excess of need by \$3,213	Overaward \$3813 Allowable amount <u>600</u> Net overaward <u>\$3213</u>	Federal regulations require that the amount of the net overaward over a \$200 threshold be refunded to the appropriate federal financial aid program.

Management Response:

Finding: As a result of a programmed procedure to test all financial aid recipients for possible overawards, three students received aid in excess of need by \$3,213.

Overaward	\$3,813
Allowable Amount	<u>600</u>
	<u>\$3,213</u>

Comment/  
Action

Taken: The overawards comprised three students.

1. James T. Studios, 000-00-0000, had a Perkins Loan, which has since been replaced in full by a University loan, eliminating the overaward. He had no further federal aid.
2. Mitch L. Academic, 123-45-6789, received SEOG funds, which created an overaward. SEOG was cancelled and replaced with a University Scholarship, eliminating the overaward.
3. George R. Scholar, 987-65-4321, was simultaneously awarded a Pell Grant and a Guaranteed Student Loan. The loan was processed without a knowledge of the student's Pell eligibility, and the amount certified was the amount to which Scholar was entitled at the time of certification, based upon the information at hand. According to federal regulations, therefore, no overaward exists. No action was taken.



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 (i) 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, (ii) reporting on our determination that the internal control structure provides reasonable assurance of compliance with federal and other laws and regulations; and (iii) the expression of an opinion on whether the organization complied with specific terms and conditions of its major federal award programs.

As a 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 major federal award programs is the responsibility of management. As required by OMB Circular A-133, we will determine and report on whether the entity 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, 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, 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 others 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]

## GLOSSARY

**Award.** Defined in OMB Circular A-133 as financial assistance 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.

**Compliance supplement.** 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 1985). It specifies the general and specific program compliance requirements and suggested audit procedures for sixty-two federal financial assistance programs. The OMB also plans to publish a supplement to OMB Circular A-133, Compliance Supplement for Single Audits of Educational Institutions and Other Nonprofit Institutions.

**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 5 of this proposed SOP.

**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.

**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.

**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." (See paragraph 4.39 of this proposed SOP.)

**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 three percent of total federal funds expended or \$100,000. Each of the following categories of federal award constitutes a major program:

1. Research and development
2. Student financial aid
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.

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. Established audit requirements and defined federal responsibilities for implementing and monitoring federal requirements.

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 the 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.

**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.

**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.

**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.

**Specific requirements.** Defined in the compliance supplements as those requirements that are specific to sixty-two federal programs that provide approximately 90 percent of the federal aid to state and local governments. These requirements generally pertain to the following categories:

1. Types of services allowed or unallowed
2. Eligibility
3. Matching, level of effort, or earmarking
4. Reporting
5. Special tests and provisions