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Proposed statement of position : audits of state and local governmental entities receiving federal financial assistance ;Audits of state and local governmental entities receiving federal financial assistance; Exposure draft (American Institute of Certified Public Accountants), 1991, July 31

American Institute of Certified Public Accountants. Government Accounting and Auditing Committee

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EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

AUDITS OF STATE AND LOCAL GOVERNMENTAL ENTITIES RECEIVING FEDERAL FINANCIAL ASSISTANCE

**(Proposed Supersession of AICPA Audit and Accounting Guide
Audits of State and Local Governmental Units, Chapter 3, paragraphs
3.1–3.4, and Chapters 21–23, and SOP 89-6, *Auditors' Reports in
Audits of State and Local Governmental Units*, Example 23)**

JULY 31, 1991

**Prepared by the Government Accounting and Auditing Committee
American Institute of Certified Public Accountants**

**Comments should be received by October 29, 1991, and addressed to
Anna Young, Technical Manager, Federal Government Division, File J-3-402
AICPA, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007**

SUMMARY

This proposed statement of position (SOP) supersedes chapter 3, paragraphs 3.1-3.4, and chapters 21-23 of the AICPA Audit and Accounting Guide Audits of State and Local Governmental Units and example 23 of SOP 89-6, Auditors' Reports in Audits of State and Local Governmental Units, and provides additional guidance on compliance auditing and single audits. The SOP updates the guide to reflect the following standards affecting the audits of federal financial assistance programs under the Single Audit Act:

- o Statement on Auditing Standards (SAS) No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit
- o SAS No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit
- o SAS No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance
- o The 1988 revision of Government Auditing Standards, issued by the Comptroller General of the United States

The recommendations in this SOP are effective for audits done in accordance with the Single Audit Act for fiscal years beginning on or after January 1, 1991. Earlier application is permissible.

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, and with administration of federal financial assistance programs.
- o Persons who have requested copies.

July 31, 1991

Accompanying this letter is an exposure draft of a proposed statement of position (SOP) titled Audits of State and Local Governmental Entities Receiving Federal Financial Assistance. It has been prepared by the 1989-1990 AICPA Government Accounting and Auditing 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 financial assistance programs, and other interested parties. This proposed SOP has been developed to provide additional guidance on compliance auditing and single audits and supersedes chapter 3, paragraphs 3.1-3.4, and chapters 21-23 of the AICPA Audit and Accounting Guide Audits of State and Local Governmental Units and example 23 of SOP 89-6, Auditors' Reports in Audits of State and Local Governmental Units. The statement updates the guide to reflect the following standards affecting the audits of federal financial assistance programs under the Single Audit Act:

- o Statement on Auditing Standards (SAS) No.55, Consideration of the Internal Control Structure in a Financial Statement Audit
- o SAS No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit
- o SAS No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance
- o The 1988 revision of Government Auditing Standards, issued by the Comptroller General of the United States

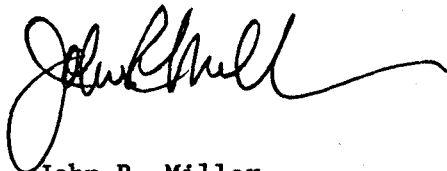
It is the committee's intent that the final issuance of this SOP will reflect the guidance in the final SAS titled Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance. It will also incorporate SOP 89-6 and SOP 90-9, The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act.

Comments or suggestions on any aspect of this exposure draft will be appreciated. It will be helpful if the responses refer to the specific paragraph numbers and include supporting reasons for any suggestions or comments.


Comments on this exposure draft should be sent to Anna Young, Technical Manager, Federal Government Division, File J-3-402, American Institute of Certified Public Accountants, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, in time to be received by October 29, 1991.

Written comments on the exposure draft will become part of the public record of the AICPA until November 30, 1992.

Yours truly,



John R. Miller
Chairman
1989-90 Government Accounting
and Auditing Committee



Gerard L. Yarnall
Director
Audit and Accounting Guides

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CHAPTER 1

INTRODUCTION TO THE SINGLE AUDIT

PURPOSE OF THIS STATEMENT

1.1 The purpose of this statement is to give auditors a basic understanding of the work they should do and the reports they should issue for audits of state and local governmental entities in accordance with the Single Audit Act of 1984 (Single Audit Act, or the "Act"). To achieve this purpose, this statement synthesizes the guidance and requirements of the various federal government and AICPA literature on single audits of state and local governments. This statement supersedes chapter 3, paragraphs 3.1 through 3.4, and chapters 21 through 23 of the AICPA Audit and Accounting Guide Audits of State and Local Governmental Units and example 23 of SOP 89-6, Auditors' Reports in Audits of State and Local Governmental Units. This statement is not intended to be applied to audits of colleges, universities, or not-for-profit organizations in accordance with Office of Management and Budget (OMB) Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions. Guidance on performing such audits has been proposed in the AICPA's exposure draft of a proposed statement of position titled Audits of Not-for-Profit Organizations Receiving Federal Awards.

THE SINGLE AUDIT ACT

1.2 The Single Audit Act established requirements for audits of financial statements of state and local governments and for testing and reporting on internal controls and compliance with laws and regulations relevant to federal financial assistance programs. A brief history of the single audit concept, which may be useful in obtaining an understanding of the requirements auditors face today, is presented in appendix A. The Act calls for the director of the OMB to issue policies, procedures, and guidelines for implementing the Act.

1.3 The Act was enacted to achieve the following goals:

- o Improve the financial management of state and local governments with respect to federal financial assistance programs
- o Establish uniform requirements for audits of federal financial assistance provided to state and local governments
- o Promote efficient and effective use of audit resources
- o Ensure that federal departments and agencies, to the maximum extent practicable, rely on and use audit work done pursuant to the Single Audit Act

1.4 The Single Audit Act and OMB Circular A-128, Audits of State and Local Governments, require state and local governments that receive total federal financial assistance equal to or in excess of \$100,000 in a fiscal year to have an audit performed in accordance with the Act.

1.5 The Single Audit Act states that a state or local government receiving at least \$25,000, but less than \$100,000, of total federal financial assistance in their fiscal year has the option of having an audit performed in accordance either with the Act or with federal laws and regulations governing the programs in which the government participates. Governments receiving less than \$25,000 in federal assistance in a year are not required to have an audit.

SINGLE AUDIT LITERATURE

1.6 The OMB has provided guidance in Circular A-128, the Compliance Supplement for Single Audits of State and Local Governments, and Questions and Answers on the Single Audit Provisions of OMB Circular A-128. Additional guidance has been provided by the Standards Committee of the President's Council on Integrity and Efficiency (PCIE), which represents the Federal Inspectors General, and by the AICPA. PCIE Statement No. 2 describes the "50-percent rule" on the consideration of the internal control structure used in administering the major federal financial assistance programs. PCIE Statement No. 3 addresses the use of a cyclical approach to conducting preliminary reviews of internal controls. Single audit guidance in addition to the OMB and PCIE guidance mentioned previously is discussed in appendix B, which describes the single audit literature in effect as of January 1991. The AICPA guidance includes--

- o Statement on Auditing Standards (SAS) No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance.
- o Statement of Position (SOP) 90-9, The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act.
- o SOP 89-6, Auditor's Reports in Audits of State and Local Governmental Units.
- o Audit and Accounting Guide Audits of State and Local Governmental Units.

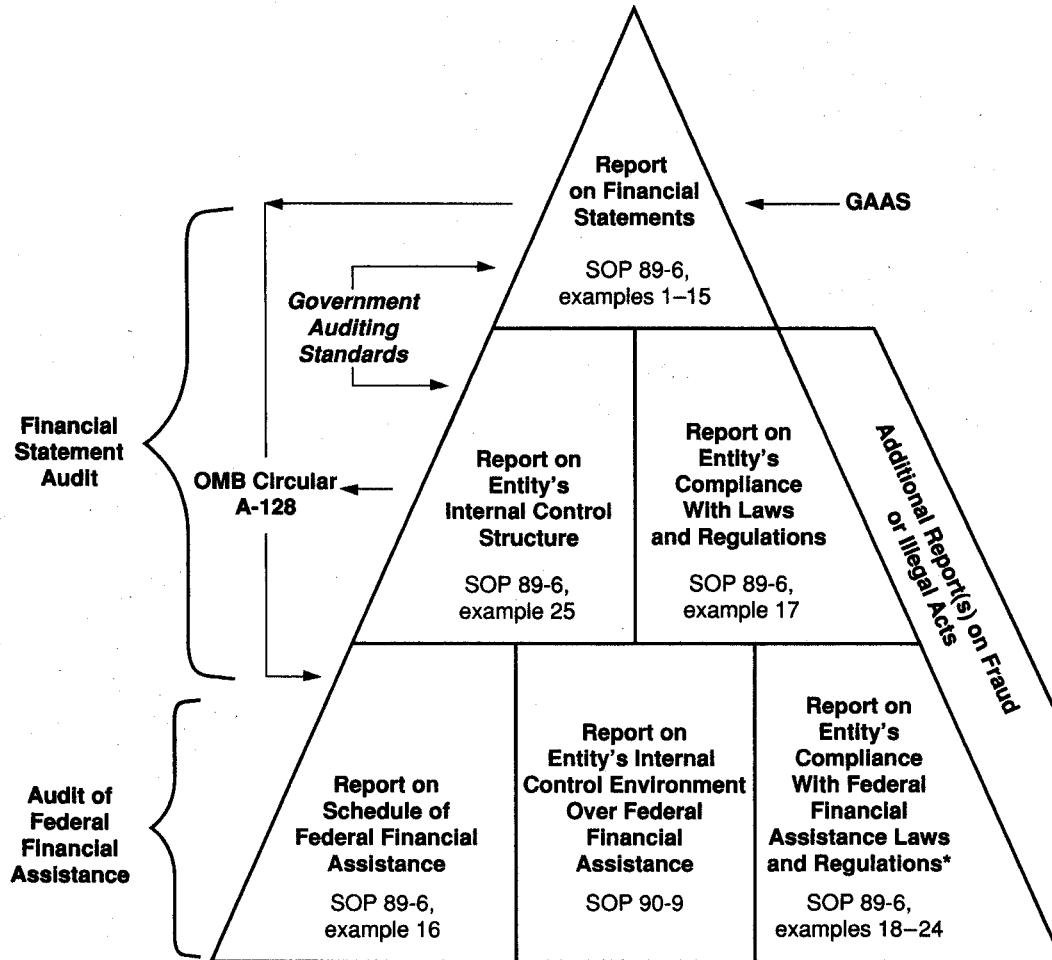
COMPONENTS OF A SINGLE AUDIT

1.7 A single audit has two main components: an audit of the financial statements and an audit of federal financial assistance. Each component results in a variety of audit reports. An overview of the various reports issued in a single audit is presented in exhibit 1.1.

Financial Statement Audit

1.8 The financial statement audit is performed in accordance with Government Auditing Standards, issued by the Comptroller General of the United States, and results in a report on the financial statements. The primary sources of guidance and standards on auditing the financial statements of state and local governments are the AICPA Audit and Accounting Guide Audits of State and Local

LEVELS OF REPORTING IN GOVERNMENTAL SINGLE AUDITS



*May be more than one report under SAS No. 63:

- General compliance (SOP 89-6, example 23)
- Major programs (SOP 89-6, examples 18-22)
- Nonmajor programs (SOP 89-6, example 24)

Governmental Units and the SASs issued after the guide was published (SAS Nos. 50 through 65). AICPA Current Industry Developments State and Local Governmental Developments--1991 and chapter 6 of this statement update guidance on financial statement audits for changes in professional standards and recent developments in the government operating environment.

1.9 A financial statement audit in accordance with Government Auditing Standards also results in two other reports. The results of procedures performed in the financial statement audit form the basis for reports on compliance with laws and regulations and on the internal control structure. Reports on compliance and internal controls that are by-products of the financial statement audit are discussed in SAS No. 63.

Audit of Federal Financial Assistance

1.10 In an audit of federal financial assistance, the auditor should issue a report on the schedule of financial assistance that the Single Audit Act requires state and local governments to prepare. Chapter 3 of this statement addresses the schedule of federal financial assistance. The auditor should also issue reports on compliance with laws and regulations applicable to federal financial assistance and on internal control structure policies and procedures relevant to compliance with those laws and regulations. These reports are issued in addition to those that are by-products of the financial statement audit. The various levels of reporting in a single audit of state and local government are shown in exhibit 1.1.

KEY CONCEPTS IN AUDITING FEDERAL FINANCIAL ASSISTANCE

1.11 Two factors, the relative size of federal financial assistance programs and the compliance requirements applicable to those programs, determine the scope of the auditor's work and the reports to be issued in an audit of federal financial assistance.

Size--Major vs. Nonmajor Programs

1.12 The Single Audit Act established the following criteria for determining if a federal financial assistance program is a major program:

<u>When Total Cash and Noncash Expenditures of Federal Financial Assistance (FFA) for ALL Programs Are--</u>		<u>Major Federal Assistance Program (MFAP) Means Any Program With Expenditures</u>
<u>More Than</u>	<u>Less Than</u>	<u>That Exceed</u>
--	\$ 10 Million	\$300,000
\$ 10 Million	\$100 Million	3% of FFA
\$100 Million	\$ 1 Billion	\$ 3 Million
\$ 1 Billion	\$ 2 Billion	\$ 4 Million
\$ 2 Billion	\$ 3 Billion	\$ 7 Million
\$ 3 Billion	\$ 4 Billion	\$10 Million
\$ 4 Billion	\$ 5 Billion	\$13 Million
\$ 5 Billion	\$ 6 Billion	\$16 Million
\$ 6 Billion	\$ 7 Billion	\$19 Million
\$ 7 Billion	--	\$20 Million

1.13 In applying the foregoing criteria, recipients of federal financial assistance should consider all forms of federal assistance, including those that may not involve expenditures, such as loans or loan guarantees. Question 33 in OMB's November 1987 Questions and Answers on the Single Audit Provisions of OMB Circular A-128 addresses how such programs are treated in the schedule of federal financial assistance and how to determine if they are major programs. Any federal financial assistance program with insufficient expenditures to be a major program is a nonmajor program. The auditor's responsibilities for major programs are generally greater than those for nonmajor programs. Additional guidance on determining whether a program is major or nonmajor is provided in chapter 3, which discusses the Supplementary Schedule of Federal Financial Assistance. A further discussion on loan guarantees is provided in chapter 4, "Performing the Audit of Federal Financial Assistance Programs."

Compliance Requirements

1.14 The term compliance requirements refers to the laws, regulations, and other requirements that should be considered in an audit of federal financial assistance. The Single Audit Act refers to compliance requirements in general terms such as "laws and regulations that may have a material effect upon the financial statements" and "laws and regulations that may have a material effect upon each major federal assistance program." Certain types of compliance requirements are mentioned in OMB Circular A-128 and in the Compliance Supplement for Single Audits, which was issued by the OMB to assist auditors in performing single audits and to supplement OMB Circular A-128. Others represent a consensus among the OMB, federal inspectors general, and auditors about requirements that may have a material effect on the financial statements or may have a material effect on a major program. The compliance requirements relevant to single audits consist of specific requirements and general requirements.

Specific Requirements

1.15 Specific requirements that, if not complied with, could have a material effect on a federal financial assistance program generally pertain to the following matters:

- o Types of services allowed or not allowed
- o Eligibility
- o Matching, level of effort, or earmarking
- o Reporting
- o Special tests and provisions

(See paragraph 4.20 for a more detailed discussion of these matters.)

1.16 The Compliance Supplement for Single Audits describes specific requirements for many of the larger federal financial assistance programs and suggests procedures for testing compliance with the specific requirements. Besides describing these specific requirements, the Compliance Supplement

includes references to the Code of Federal Regulations (CFR) and other sources of information about the requirements. The auditor should consider referring to these other sources of information in planning to test compliance with specific requirements. The auditor should also be aware that compliance requirements may change over time.

1.17 To obtain an understanding of specific requirements of programs not included in the Compliance Supplement, the auditor should consider reviewing the Catalog of Federal Domestic Assistance (CFDA). The CFDA, which is generally updated on an annual basis, contains all federal financial assistance programs, together with citations to applicable laws and regulations associated with those programs. It also contains the names of the program staff members who serve as reference individuals for each program.

General Requirements

1.18 The Compliance Supplement identifies the following nine requirements as general compliance requirements applying to all federal financial assistance programs:

1. Political activity (Hatch Act and Intergovernmental Personnel Act of 1970, as amended)
2. Davis-Bacon Act
3. Civil rights
4. Cash management
5. Relocation assistance and real property acquisition
6. Federal financial reports
7. Drug-free workplace
8. Allowable costs/Cost principles
9. Administrative requirements

1.19 The Compliance Supplement suggests procedures for testing compliance with the general requirements. As the Single Audit Act has been implemented, it has become generally accepted that the nature of these procedures is sufficient to satisfy the requirements of the Act with respect to the general requirements. However, the Compliance Supplement does not specify the extent of such procedures. The auditor should exercise professional judgment in determining the extent of procedures for testing compliance with the general requirements.

1.20 The general requirement dealing with administrative requirements encompasses OMB's publication Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments--Final Rule (the "Common Rule"). The Common Rule was developed to establish consistency and uniformity among the various federal agencies in the administration of grants and cooperative agreements to state, local, and federally recognized Indian tribal governments. This rule is effective for grants and cooperative agreements awarded on or after October 1, 1988.

1.21 The Common Rule requirements apply to federal assistance in the form 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.

1.22 Three administrative requirements--cash management, financial reporting, and cost principles--are explicitly included among the general requirements. Other requirements included in the Common Rule could have a material effect on a federal financial assistance program and thus may need to be included in the general requirements of an audit of federal financial assistance. Further guidance is presented in chapter 4 on performing the audit of federal financial assistance.

AUDITORS' RESPONSIBILITIES IN AUDITS OF FEDERAL FINANCIAL ASSISTANCE-- AN OVERVIEW

1.23 In audits of federal financial assistance, the auditor's responsibility for testing and reporting on internal controls and compliance is determined by the size of each federal financial assistance program and the compliance requirements applicable to it. The following sections briefly describe how program size and compliance requirements determine the scope of each component of the audit of federal financial assistance. (See exhibit 1.2 at the end of this chapter for a graphic representation of how program size and compliance requirements determine the scope of the auditor's work and the reports he or she issues.)

Internal Control Structure Over Federal Financial Assistance

1.24 In audits of federal financial assistance done as part of a single audit, 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 usually is in addition to the consideration of the internal control structure done as part of the financial statement audit.

1.25 For all major federal financial assistance programs, the auditor should test the operating effectiveness of internal control structure policies and procedures 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 the auditor can use in the audit of compliance with specific requirements applicable to major programs.

1.26 If major programs comprise less than half of total federal assistance, the auditor should test controls over the largest nonmajor programs until at least half the federal assistance has been subject to a test of controls.

1.27 For remaining federal financial assistance 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 performance of walk-throughs. In some circumstances, auditors may perform this work on a cyclical basis, reviewing controls over

different programs each year. The cyclical approach has limited application and is not intended to be used on the vast majority of single audit engagements.

1.28 Further guidance is contained in SOP 90-9 and in chapter 4 of this statement.

Compliance With Laws and Regulations

1.29 The interaction between program size and type of compliance requirement results in three distinct levels of responsibility for testing and reporting on compliance with laws and regulations in an audit of federal financial assistance. A summary of these responsibilities, together with a brief discussion of the schedule of findings and questioned costs, follows immediately. Detailed guidance on carrying out these responsibilities is presented in chapter 4, and a detailed discussion of the schedule of findings and questioned costs is presented in chapter 5.

Specific Requirements--Major Programs

1.30 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, would likely form part of the basis for the opinion on compliance.

Specific Requirements--Nonmajor Programs

1.31 If the auditor selects any nonmajor program transactions during the financial statement audit or during the internal control work in the audit of federal financial assistance, he or she should test those transactions for compliance with eligibility, allowability, and the relevant specific requirements applicable to the nonmajor program transactions selected. The auditor's report should provide positive assurance about items tested and negative assurance about items not tested. If the auditor did not select any nonmajor federal financial assistance program transactions, or if the entity has no nonmajor programs, no report describing that situation is required.

General Requirements--Major and Nonmajor Programs

1.32 The auditor should perform tests of compliance for all of the general requirements. SAS No. 63 established that the procedures suggested in the Compliance Supplement would be sufficient to satisfy single audit requirements. Typically, many of these procedures would be performed as part of the internal control work in the audit of federal financial assistance. The auditor's report should provide positive assurance about items tested and negative assurance about items not tested.

1.33 The auditor should issue a report on compliance with general requirements regardless of whether the government being audited has major programs. Determining the extent of any tests of compliance with general requirements as they pertain to nonmajor programs is a matter of professional judgment. Among the matters the auditor considers are the extent of any tests of compliance with general requirements performed for major programs. If the government being audited has no major programs, the auditor should consider whether his or her tests of controls over compliance with general requirements

provides evidence that would also support a report on compliance. If the tests of controls do not provide sufficient evidence to support a report on compliance, additional procedures on the general requirements would need to be performed.

Findings and Questioned Costs

1.34 The auditor's tests of compliance with laws and regulations may disclose instances of noncompliance or "questioned costs." All instances of noncompliance and questioned costs, regardless of materiality, should be reported in a schedule of findings and questioned costs. Although the auditor may issue as many as four different compliance reports in a single audit, findings and questioned costs are typically presented in one schedule.

SINGLE AUDIT MATRIX

1.35 The matrix presented in exhibit 1.2 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 in both the internal control and compliance aspects of an audit of federal financial assistance.

SINGLE 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	Nonmajor to achieve 50% Internal Control Compliance	Nonmajor to achieve 50% Internal Control Compliance	Other Nonmajor Programs Internal Control Compliance
GENERAL REQUIREMENTS	T +/-	U β (2)	T +/-	T β (2)	T β (2)	U β (2)
SPECIFIC REQUIREMENTS	T Opinion	U β (1)	T Opinion	T β (1)	T β (1)	U β (1)

- Legend**
- +/- = Positive/Negative Assurance
 - β = 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 financial assistance 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, requires the auditor 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.

CHAPTER 2

SINGLE AUDIT PLANNING

AUDITING AND REPORTING CONSIDERATIONS

2.1 The scope of the single audit was discussed in chapter 1. In planning single audits, auditors should determine the nature, timing, and extent of work to be performed and prepare written audit programs. The Single Audit Act, OMB Circular A-128, and Government Auditing Standards establish audit requirements to satisfy the needs of federal program managers and other users of the federal financial assistance program financial statements and reports.

2.2 In planning an audit in accordance with the Single Audit Act, 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 a single audit, as well as matters to be considered in planning the audit of federal financial assistance. Matters relevant to planning the financial statement audit component of the single audit are discussed in detail in chapter 6 of this statement on financial statement audit considerations.

OVERALL SINGLE AUDIT PLANNING CONSIDERATIONS

2.3 Matters that are relevant to planning both components of a single audit--the financial statement audit and the audit of federal financial assistance--include the following:

- o Relationships with and responsibilities of the cognizant agency
- o Government Auditing Standards
- o Reporting entity definition
- o Determination of the audit period
- o Initial-year audit considerations
- o Joint audit considerations
- o State grant compliance requirements
- o Engagement letters
- o Higher-level audit services

Relationships With and Responsibilities of the Cognizant Agency

2.4 OMB Circular A-128 defines the cognizant agency as the federal agency assigned by the OMB to carry out the responsibilities with respect to single audits of governments as defined in paragraph 11 of the circular. Independent

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 and the recipient organization such matters as the audit plan, the scope of testing of programs for specific compliance requirements, the intended use of the OMB's Compliance Supplement, any sampling plan, and other audit matters, as deemed appropriate.

2.5 The following subjects may also be discussed during the initial single audit planning meeting:

- o The scope of the audit (that is, the single audit reporting entity)
- o The form and content of the schedule of federal assistance
- o The scope of the understanding and assessment of the internal control structure (including the government's significant internal control policies and procedures, including those controls designed to provide reasonable assurance that federal programs are being managed in compliance with laws and regulations)
- o The auditor's reports on compliance and internal control
- o Identification of federal financial assistance programs, including those that are considered major
- o Testing of compliance requirements, including the sampling plan
- o The audit approach for subrecipients

If the cognizant agency disagrees with the significant elements of the audit plan or any other significant items, these matters should be resolved between the recipient, the cognizant agency, and the auditor before fieldwork commences. Contacts with and decisions rendered by the cognizant agency should be documented.

2.6 The OMB has designated cognizant agencies for state agencies and large local governmental units. Smaller governments not assigned a cognizant agency are under the general oversight of the federal agency that provides them with the most funds, whether directly or indirectly.

2.7 OMB Circular A-128 states that a cognizant agency shall have the following responsibilities:

- o Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of the circular.
- o Provide technical advice and liaison to state and local governments and independent auditors.
- o Obtain or make quality control reviews of selected audits made by nonfederal audit organizations, and provide the results, when appropriate, to other interested organizations.

- o Promptly inform other affected federal agencies and appropriate federal and local law enforcement officials of any reported illegal acts or irregularities.
- o Advise the recipient of audits that have been found not to have met the requirements set forth in the circular. In such instances, the recipient will be expected to 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 result in referral of the auditor to appropriate professional bodies for disciplinary action.
- o Coordinate, to the extent practicable, audits made by or for federal agencies that are in addition to the audits made pursuant to the circular, so that the additional audits build upon such audits.
- o Oversee the resolution of the audit findings that affect the programs of more than one agency.

Additional information on cognizant agency responsibility is contained in the Federal Cognizant Agency Audit Organization Guidelines (the "Orange Book"). It provides guidance for promoting quality audits, processing audit reports, and providing notification of irregularities. Auditors should be familiar with its contents before conducting a single audit.

2.8 Although each federal agency has agreed to exercise its cognizant responsibilities in accordance with policies set forth in the Orange Book, those guidelines are limited to broad policy statements and leave the design and execution of specific procedures to the individual cognizant agencies. The auditor should not presume that all conditions agreed to by a cognizant agency for one engagement will be the same for other engagements.

2.9 General Oversight Agencies. 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 governments within a state even though that department or agency does not provide the most funds to every government in that class. An example might be the Department of Health and Human Services assuming oversight responsibilities for all counties in a state because of their continuing involvement in social service programs.

Government Auditing Standards

2.10 The Single Audit Act and OMB Circular A-128 require the audit to be performed by an independent auditor in accordance with Government Auditing Standards (1988 revision), issued by the Comptroller General of the United States. The fieldwork standard for financial audits states that "working papers should contain sufficient information so that supplementary oral

explanations are not required." The sufficiency of working papers in government audits is particularly important because those working papers could be subject to a review by federal inspectors general. Appendix D to this statement describes federal quality control procedures. Two other significant requirements included in Government Auditing Standards are continuing professional education and external quality control review.

2.11 Continuing Professional Education Requirements. Government Auditing Standards requires auditors to participate in a program of continuing education and training. Certain auditors performing audits in accordance with Government Auditing Standards should complete at least eighty credit hours that contribute directly to the auditor's professional proficiency to perform the audit every two years. Of these eighty hours, at least twenty-four should be devoted to subjects directly related to the government environment and to government auditing. The twenty-four-hour requirement applies to those planning, directing, reporting, and conducting substantial portions of fieldwork. An interpretation of the CPE standards and their applicability was issued in April 1991 by the U.S. General Accounting Office. Auditors and audit organizations should ensure during engagement planning that appropriate members of the audit team have met the CPE requirement.

2.12 External Quality Control Review. Government Auditing Standards also states that the audit organization should have an internal quality control system in place and participate in an external quality review program (such as peer or quality review). An external quality review should be conducted once every three years. The first review should be completed on or before December 31, 1991.

2.13 Failure to Follow Government Auditing 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 a governmental engagement and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, the auditor is obligated to follow those standards or guidelines in addition to generally accepted auditing standards (GAAS). Failure to do so is an act discreditable to the profession in violation of Rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that those standards or guidelines were not followed and the reason therefor is presented. For additional guidance, auditors should refer to subsequent sections of this chapter and to chapters 3 and 4, which identify additional auditor responsibilities and considerations under the Single Audit Act, OMB Circular A-128, and Government Auditing Standards.

Reporting Entity Definition

2.14 One of the initial tasks during the planning process of a single audit is defining the reporting entity.

2.15 The Single Audit Act does not elaborate on what constitutes a government's entire operations, except that it does allow governments the option of excluding public hospitals, colleges, and universities. The most easily supported definition of the entity will be one that is consistent with GASB Codification Section 2100, "Definition of the Reporting Entity."

2.16 The Act also permits the recipient government to limit its single audit to cover only those departments or agencies that received, expended, or otherwise administered federal financial assistance. To date, very few governments have found the limitation on departments and agencies handling federal financial assistance to be beneficial. Finally, the Act permits a series of audits of individual departments or agencies; in general, this option has been elected only by state and larger local governments.

Determination of the Audit Period

2.17 Audits of federal assistance programs are required to be performed annually unless the state or local government has--by January 1, 1987--a constitutional or statutory requirement for less frequent audits. For such governments, the cognizant agency is empowered to permit biennial audits, covering both years, if the government so requests. The cognizant agency may also honor requests for biennial audits by governments that have an administrative policy calling for audits less frequent than annually, but only for fiscal years beginning before January 1, 1987.

2.18 A single audit should cover the reporting entity's financial transactions for its fiscal year, not the grant year or period of the program being funded. Thus, the audit might include only a portion of the transactions of certain assistance programs. If a program's transactions occur either before the beginning of the period covered by the audit or after this period, they should be included as part of the single audit for the previous or subsequent year. If a single audit is not performed in either the previous or subsequent period, the transactions are included in what is called a "stub period." Stub periods are considered those time periods (a) from the last grant audit to the first single audit and (b) between single audits.

2.19 Although it may appear that "stub periods" only existed when the Single Audit Act was first implemented, this is not always true. Many governments may be subject to the Single Audit Act once every few years because the amount of federal assistance they receive does not qualify them every year, and each year, governments that were not previously subject to the Act are becoming so. For such governments, stub period concepts are important.

2.20 There are at least five options that have been developed relative to stub period transactions:

- o Arrange for a separate program audit for the stub period.
- o Use the same detailed audit guide and reports as the most recent audit.
- o Arrange to have a "special" audit of the stub period. Technically called "agreed-upon procedures," these audit procedures are usually negotiated with the federal government.
- o Arrange to extend the initial single audit "back" into the stub periods for the affected programs. Audit results would be included in the initial single audit report.
- o Inquire of the federal government and be prepared to negotiate program by program.

Initial-Year Audit Considerations

2.21 An auditor accepting, or contemplating accepting, an engagement in which the federal financial assistance programs of the preceding period were audited by another auditor should be guided by SAS No. 7, Communications Between Predecessor and Successor Auditors. If the federal financial assistance programs 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 required, the Act and Circular A-128 provide for the federal agency to arrange for funding the cost of such additional audit work.

Joint Audit Considerations

2.22 In conducting a single audit, there may be instances in which it will be necessary to refer to the work of other auditors in a principal auditor's report. There may be instances in which the audit may be performed by more than one auditor, such as in prime-subcontractor or joint-examination arrangements.

2.23 The Single Audit Act requires OMB to prescribe policies, procedures, and guidelines "as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the Single Audit Act requirements" (section 7505(c)). Circular A-128 provides such guidelines.

2.24 Accordingly, many governments have required that their single audits be performed on a joint venture or subcontract basis with small, minority-owned or female-owned independent accounting firms.

2.25 Prior to entering an agreement to perform a joint audit or subcontract with another firm, the auditor should follow the guidance in AICPA Professional Standards, volume 1, AU section 543, "Part of an Examination Made by Other Independent Auditors," and with AICPA Ethics Interpretation 101-10.

2.26 At a minimum, the principal auditor in a joint audit should--

- o Ensure his or her own independence of the oversight entity and each component unit in the reporting entity.
- o Confirm the other auditor's independence under Ethics Interpretation 101-10.
- o Obtain separate audited financial statements of each component unit or federal program included.
- o Ascertain that an appropriate subsequent events 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.

If the joint audit is performed with governmental auditors, the auditors should be satisfied that the government auditors meet the independence standards of Government Auditing Standards. Those standards require that government auditors be free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance.

2.27 In some circumstances the independent auditors participating in the examination will each have signed the report in their individual capacities. Each individual or firm signing the audit report should be considered to be separately expressing 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.

2.28 Another common occurrence is the conducting of a separate single audit by an auditor, other than the principal auditor, of a component unit included in the financial statements of an oversight entity. The auditor's report on the financial statements of the oversight entity most often refers to the report of the other auditor as it relates to the financial statements of the component unit. The auditor may also need to refer to the programs audited by other auditors in their report on the schedule of federal financial assistance. In such cases the auditor should follow the guidance in AU section 543. When conducting a single audit, auditors are required to issue reports on compliance and internal control. 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. Reliance on the work of other auditors may not be appropriate for the auditor to issue reports on the oversight entity's internal control structure or compliance with laws and regulations. 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.

State Grant Compliance Requirements

2.29 In addition to the compliance requirements imposed on auditors by the Single Audit Act and OMB Circular A-128, there may be state grant compliance requirements, since many states also make grants to their political subdivisions and, as does the federal government, prescribe audit requirements. In conjunction with the financial statement audit, the auditor should obtain an understanding of (a) applicable state reporting and compliance requirements that may be material to the financial statements being audited and (b) the SAS Exposure Draft Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance, which as a final document will replace SAS No. 63. If engaged to audit state grant activity, the auditor should also obtain an understanding of any special auditing and reporting requirements prescribed by the state.

2.30 When the engagement includes auditing state compliance with a grant, the auditor should consider performing the following steps:

- o Obtain any applicable audit guidance from the state grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.

- o Discuss and obtain agreement with the state grantor agency on the scope of testing that is expected to be performed.

2.31 Nonfederal assistance received by an entity should be distinguished from the federal "pass-through" funds received. These pass-through funds, discussed in paragraph 3.6, are considered part of the total federal financial assistance received by an entity and are subject to audit in accordance with the Single Audit Act and OMB Circular A-128. The recipient of federal financial assistance that provides pass-through funds to a subrecipient has the responsibility of notifying the subrecipient of (a) the amount of federal assistance included in the pass-through and (b) the federal program name and number from which such assistance was derived.

Engagement Letters

2.32 It is in the best interest of both the auditor and the entity to document the scope of the audit in an engagement letter. This will minimize confusion and help ensure a proper understanding of the responsibilities of each party.

2.33 In addition to the elements of an engagement letter discussed in paragraphs 5.1 to 5.4 of the AICPA Audit and Accounting Guide Audits of State and Local Governmental Units, auditors should consider including items such as the following: (a) the additional reports required by the Single Audit Act and OMB Circular A-128 and (b) the auditor's and entity's responsibility with respect to reporting illegal acts noted during the audit (pages 5-4 to 5-6 of Government Auditing Standards).

2.34 In addition to issuing 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, what the major programs to be audited are, and how the other areas listed in this chapter will be handled. By gaining the concurrence of the agency, auditor, and auditee, questions and misunderstandings during the audit and after the audit is completed can be avoided.

Higher-Level Audit Services

2.35 If auditors are engaged to perform an audit in accordance with GAAS and during the course of the audit discover that the entity should be obtaining an audit in accordance with Government Auditing Standards or the Single Audit Act, the proposed SAS amending SAS No. 63 would require the auditor to notify the entity of the requirement for a higher level of service. This communication can be either verbal or in writing, but if done verbally, the communication should be documented in the audit working papers. Circumstances that may indicate higher-level audit requirements include (a) a review of laws, contracts, policies, or grant agreements that require higher-level audit services and (b) the discovery that the government received over \$25,000 in federal assistance in the year under audit.

PLANNING THE AUDIT OF FEDERAL FINANCIAL ASSISTANCE

2.36 Among the more significant matters that should be considered in planning the audit of federal financial assistance is materiality.

2.37 In auditing compliance with requirements governing major federal financial assistance programs in accordance with the Single Audit Act and OMB Circular A-128, 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 (that is, at the fund-type or individual fund financial statement level). However, in auditing an entity's compliance with requirements governing major federal financial assistance programs in accordance with the Single Audit Act, materiality is considered in relation to each major program.

2.38 Because SAS No. 63 requires the auditor to provide an opinion on compliance with specific requirements of each major program and not on all the major programs combined, reaching a conclusion about whether instances of noncompliance--either individual or in the aggregate--are material to a major federal financial assistance program requires consideration of the type and nature of the noncompliance as well as the actual and projected impact of the noncompliance on the major federal financial assistance program in which the noncompliance was noted. An amount that is material to one major federal financial assistance program may not be material to a major federal financial assistance program of a different size. Furthermore, the level of materiality relative to a particular major federal financial assistance program can change from one period to another. Notwithstanding materiality, all instances of noncompliance discovered and any related questioned costs should be included in the auditor's report on compliance to comply with OMB Circular A-128.

2.39 Other important planning considerations include--

- o Identification of federal financial assistance programs (see the discussion of the Supplementary Schedule of Federal Financial Assistance in chapter 3).
- o Internal control structure used in administering federal financial assistance (see chapter 4).
- o Subrecipient considerations (see the discussion of internal control structure in chapter 4).
- o Specific compliance requirements (see the discussion of compliance in chapter 4).
- o General compliance requirements (see chapter 4).
- o Findings and questioned costs (see chapter 5).
- o Reporting (see chapter 5).

CHAPTER 3

SUPPLEMENTARY SCHEDULE OF FEDERAL FINANCIAL ASSISTANCE

3.1 OMB Circular A-128 requires the auditor to report on the Supplementary Schedule of Federal Financial Assistance (the "Schedule"). The Schedule reports the total expenditures for each federal financial assistance program as identified in the Catalog of Federal Domestic Assistance (CFDA). Significant federal financial assistance programs that have not been assigned a CFDA number should be identified separately under the caption "other federal assistance."

3.2 The Schedule should list all federal financial assistance programs, both major and nonmajor (regardless of whether they are cash or noncash programs), administered by the governmental unit to facilitate identification by an agency of its federal financial assistance programs.

Types of Assistance and Payment Methods

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

Types of Assistance Programs

3.4 Currently, programs in the CFDA are classified into fifteen types of assistance. Benefits and services are provided through eight nonfinancial types of assistance and seven financial types of assistance, which may be received by governments under various ways. Some programs provide for assistance to be received directly or under reimbursement arrangements in which the recipient government bills the grantor for costs as incurred, other programs provide for advance payments, and still others permit the government to draw against letters of credit as grant expenditures are incurred. The seven principal types of financial assistance that are available to state and local governments through the programs are--

1. Formula grants--allocations of money to states or their subdivisions in accordance with a distribution formula prescribed by law or administrative regulation for activities of a continuing nature not confined to a specific project.
2. Project grants--the funding, for fixed or known periods, of specific projects or the delivery of specific services or products without liability for damages for failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, survey grants, construction grants, and unsolicited contractual agreements.

3. Direct payments--financial assistance consisting of--
 - o Direct payments for specified use--financial assistance from the federal government that is provided directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon a particular performance by the recipient. This does not include solicited contracts for the procurement of goods and services for the federal government.
 - o Direct payments with unrestricted use--financial assistance from the federal government that is provided directly to beneficiaries who satisfy federal eligibility requirements and imposes no restrictions on the recipient as to how the money is spent. Included are payments under retirement, pension, and compensation programs.
4. 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.
5. Guaranteed/insured loans--programs in which the federal government makes an arrangement to indemnify a lender against part or all of any defaults by those responsible for repayment of loans.
6. Insurance--financial assistance provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through private carrier and may or may not involve the payment of premiums.
7. Sale, exchange, or donation of property and goods--programs that provide for the sale, exchange, or donation of federal real property or personal property (including land, buildings, and equipment), commodities (including food and drugs), and other goods. This does not include the loan of, use of, or access to federal facilities or property.

3.5 Certain grants have matching requirements in which the participating state or local government must contribute a proportionate share of the total costs of a program or administrative cost allowance received.

Pass-Through Awards

3.6 The Single Audit Act and OMB Circular A-128 require that state or local government redistributions of federal financial assistance to other governments or not-for-profits, known as "pass-through awards," be treated by the last recipient as though they were received directly from the federal government. The recipient of a pass-through award is a subrecipient. Accordingly, pass-through awards should be included in tests on the same basis as federal financial assistance programs received directly. The Schedule should separately report assistance received directly and assistance received through pass-through awards.

3.7 The individual sources of governmental financial assistance may not be readily identifiable because assistance from various levels of government may have been commingled. 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 a local unit of government, supplemented with its own funds. When this occurs, the local governmental unit may be responsible for complying with both federal and state requirements governing that assistance.

3.8 If it is believed that financial assistance could represent assistance combined from various levels of government, management should review contracts or other documentation 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) to provide the source and amount of that additional assistance, if any, and the name of the program through which that assistance was provided. If the commingled portion cannot be separated so that the individual funding sources can be specifically identified, then the total amount should be included in the Supplementary Schedule of Federal Financial Assistance with a footnote describing the commingled nature of the funds. When testing these commingled funds, a conservative approach is to consider the total amount to be federal funds in order to determine the nature and extent of the tests.

Noncash Awards

3.9 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 state or local governments. These programs usually involve food stamps, food commodities, loan guarantees, loans, or insurance. The value of noncash assistance should be reported as part of the Supplementary Schedule of Federal Financial Assistance or included in a footnote to the Schedule. For example, the value of food stamps issued and commodities distributed would typically be shown on the Schedule 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 food coupons on hand and the value of commodities in inventory should be shown in the entity's financial statement or in a footnote to the financial statements.

3.10 Any interest subsidy or administrative cost allowance received during the fiscal year under a loan or loan guarantee program should be included in the Schedule.

3.11 Once all sources of federal financial assistance have been identified, assistance programs should be ranked in order of size of expenditure. To properly complete the ranking process, noncash assistance should be valued and included in the ranking. The following table should be used as a guide in valuing noncash assistance.

Types of Noncash Assistance

Base Used to Determine Value of Program

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 interest subsidy, cash, or administrative cost allowance received

Commodities

Value of commodities issued during the year

Food stamps

Value of food stamps issued during the year

Insurance

Value of insurance contract

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

3.13 Management should exercise caution when including noncash programs in the process of determining major programs, since the size of these programs may result in other programs being excluded from the definition of major programs. The OMB question-and-answer booklet 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 judgement as to whether the guarantee program should be included when determining which other programs are major."

3.14 Management, after identifying all sources of federal financial assistance, should prepare the Supplementary Schedule of Federal Financial Assistance. The information required on the Schedule includes--

- o Identification of each program (normally by program or grant title, including the federal agency and federal CFDA number) and indication that it is either direct or pass-through.
- o Presentation of those federal programs that have not been assigned catalogue numbers as other federal financial assistance.
- o Total expenditures for each federal financial assistance program, classified by grantor, department, or agency.
- o Total federal financial assistance.

3.15 Depending on the circumstances of the engagement and the requirements of the entity, the Schedule may also present the following other information for each program:

- o Matching contributions
- o Amount of the program award and time period of the award
- o Receipts or revenue recognized
- o Beginning and ending balances, such as unexpended amounts or accrued (deferred) amounts
- o Subtotals by federal grantor agency
- o Footnotes (for example, basis of accounting, reporting entity, basis for valuing noncash programs)

3.16 In assessing the completeness of the Schedule, the auditor should consider, among other things, evidence obtained from audit procedures performed in the audit of financial statements, such as procedures performed to evaluate 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.

3.17 The financial information included in the Schedule should be derived from the government's books and records from which the general-purpose financial statements were prepared. It should also be prepared as far as practicable on a basis consistent with other federal grant reports. However, the Schedule's data may not fully agree with or be traceable to other grant reports and the entity's financial statements because, among other things, (a) the grant reports may be prepared on a different fiscal period, or (b) the grant reports may include cumulative (from prior years) data rather than only current-year data.

3.18 Although a reconciliation among the Schedule, the grant reports, and the entity's financial statements should be possible, it is not required. Furthermore, it is not expected that the Schedule's data will be directly agreeable or traceable to these other reports.

3.19 Subrecipients of federal financial assistance should identify whether program funds are received directly from the federal government or received as pass-throughs from another governmental unit. For those funds received from another government, the program identifying number(s) (as well as the federal CFDA number) should be included.

3.20 Because federal agencies are the primary users of the Supplementary Schedule of Federal Financial Assistance, financial data for state and other nonfederal assistance are not usually presented in the Schedule. If such nonfederal data are presented in the Schedule, the auditor should discuss the form of presentation with the client to ensure that nonfederal data are clearly identified.

3.21 Exhibit 3.1 provides an illustration of a Supplementary Schedule of Federal Financial Assistance that incorporates the disclosure requirements of paragraph 3.14.

EXHIBIT 3.1

ILLUSTRATIVE SUPPLEMENTARY SCHEDULE OF FEDERAL FINANCIAL ASSISTANCE
FOR THE YEAR ENDED JUNE 30, 19XX

<u>Federal Grantor/Pass-Through Grantor/ Program Title</u>	<u>Federal CFDA Number</u>	<u>Pass-Through Grantor's Number</u>	<u>Expenditures</u>
<u>U.S. Department of Education</u>			
Direct Programs:			
Impact aid	84.041*	N/A	\$XXX
Bilingual education	84.003	N/A	XXX XXX
Pass-Through State Department of Education:			
Chapter 1	84.011	XXXXX	XXX
Chapter 2	84.151	XXXXX	XXX
Vocational education-- basic grants to states	84.048	XXXXX	XXX XXX
Total Department of Education			XXX
<u>U.S. Department of HUD</u>			
Direct Programs:			
Community development block grant--entitlement	14.218	N/A	XXX
Urban development action grant	14.221	N/A	XXX XXX
Pass-Through State Department of Community Development:			
Community development block grant--states program	14.219	XXXXX	XXX
Total U.S. Department of HUD			XXX
<u>Other Federal Assistance</u>			
Department of Defense			
Engineering study contract	--	--	XXX
TOTAL FEDERAL ASSISTANCE EXPENDED			==== \$XXX =====

* Major program.

CHAPTER 4

PERFORMING THE AUDIT OF FEDERAL FINANCIAL ASSISTANCE PROGRAMS

AUDITING FEDERAL FINANCIAL ASSISTANCE PROGRAMS

4.1 Federal financial assistance, as discussed in chapter 3, comes in many forms. Federal financial assistance programs come with a set of general and specific program requirements as shown in the OMB Compliance Supplement for Single Audits of State and Local Governments. Although there is no requirement that the auditor test all federal financial assistance programs and related compliance, the Single Audit Act does contain specific audit requirements for major federal financial assistance programs.

4.2 The audit of federal financial assistance results in reports on internal control and on compliance with laws and regulations. This chapter discusses the work the auditor does to provide a basis for issuing those reports. Chapter 5 discusses the reports themselves.

INTERNAL CONTROL STRUCTURE USED IN ADMINISTERING FEDERAL FINANCIAL ASSISTANCE

4.3 SOP 90-9 addresses the auditor's responsibilities for testing and reporting on the internal control structure used in administering federal financial assistance in a single audit. Further discussions of two aspects of those responsibilities, the Common Rule and subrecipient considerations, are presented below.

Common Rule

4.4 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 Common Rule. Because certain provisions of the Common Rule duplicate certain General and Specific Compliance Requirements sections of the Compliance Supplement, they do not need to be addressed separately. The auditor, however, should obtain an understanding of the internal control structure, assess control risk, and test internal control structure policies and procedures relative to the material provisions of the Common Rule not addressed in the General and Specific Requirements.

SUBRECIPIENT CONSIDERATIONS

4.5 Many primary recipient governmental units make subcontract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients. The following are some examples of a typical recipient-subrecipient relationship:

- o A state department of education receives federal assistance, which it disburses on a formula or other basis.

- o A regional planning commission receives federal funds for the feeding of elderly and low-income individuals. These funds are disbursed to a not-for-profit organization based on a contract for meal delivery.
- o A state department of social services receives federal funds, which are disbursed to a county government.

4.6 A subrecipient is defined as "any person or government department, agency or establishment that receives federal financial assistance to carry out a program through a state or local government but does not include an individual that is a beneficiary of such a program. Compliance requirements exist for monitoring the performance of subrecipients but not vendors. A subrecipient may also be a direct recipient of federal financial assistance." 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 is responsible for meeting the requirements of a procurement contract for goods or services issued by its recipient customer. When a recipient enters into a procurement contract to buy goods or services, the other party to the contract is not generally a subrecipient for purposes of the single audit. In the absence of a procurement contract or similar agreement, the party should initially be considered a subrecipient. A subrecipient relationship does not exist when a contract for units of services exists and the vendor did not participate in meeting the requirements of the assistance award. Typical of this buyer-vendor relationship is the purchase of medical services (Medicare-funded services), vocational training services, or a participating government's purchase of supplies or equipment through a regional pooled purchasing program that was funded in part by federal assistance.

4.7 Redistribution of federal financial assistance to subrecipients is normally done only on the basis of properly completed and approved grant applications. These written agreements include (a) requirements that subrecipients comply with federal conditions set by the initial federal agency and (b) any additional requirements established by the pass-through agency.

4.8 Under the requirements of the Single Audit Act, when in a single fiscal year a recipient of federal financial assistance passes \$25,000 or more of such assistance through to a subrecipient, the primary recipient is responsible for determining whether the subrecipient expends that assistance in accordance with applicable laws and regulations. Further, OMB Circular A-128 provides that in such instances, the primary recipient should--

- o Determine whether state or local subrecipients have met the audit requirements of Circular A-128 and, where applicable, whether subrecipients covered by Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions, have met those unique requirements.
- o Determine whether the subrecipient spent federal assistance funds provided in accordance with applicable laws and regulations.
- o Ensure that, within six months after receipt of the subrecipient audit report on reported instances of noncompliance with federal laws and regulations, appropriate corrective action is taken.

- 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-128.

Those responsibilities may be discharged by (a) relying on independent audits of the subrecipients, performed in accordance with OMB Circulars A-128 or A-133, (b) relying on appropriate procedures performed by the primary recipient's internal audit or program management personnel, (c) expanding the scope of the independent financial and compliance audit of the primary recipient to encompass testing of subrecipients' charges, or (d) a combination of these procedures.

4.9 The primary recipient is also responsible for (a) reviewing audit and other reports submitted by subrecipients and identifying questioned costs and other findings pertaining to the federal financial assistance passed through to the subrecipients and (b) properly accounting for and pursuing the resolution of questioned costs and ensuring that prompt and appropriate corrective action is taken on instances of material noncompliance with laws and regulations.

4.10 In establishing its system to monitor subrecipients, management should design procedures that are sufficient to detect a subrecipient's noncompliance with applicable federal laws and regulations. Financial operations of subrecipients related to the federal assistance may be subjected to timely and periodic audits. If they will 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. Review the working papers of the auditors if such a review is considered necessary. Subrecipients receiving less than \$25,000 are not required to be audited.
- o Evaluate audit findings and determine if a plan of corrective action has been prepared and implemented.
- o Review grant applications submitted by subrecipients to determine whether--
 - Applications are approved by management before any funds are awarded.
 - Applications were filed in a timely manner.
 - Each application contains the condition that the subrecipient comply with the federal requirements set by the initial federal agency.
- o Determine whether funds are disbursed to subrecipients only on an as-needed basis.

- o Determine whether disbursements to subrecipients are approved and are based on properly completed reports submitted in a timely manner.
- o Ascertain that refunds due from subrecipients are billed and collected in a timely manner.
- o Determine whether procedures exist to ensure that subrecipients and those using the funds meet all eligibility requirements.
- o Determine whether reports received from subrecipients are reviewed on a timely basis and whether all unusual items are fully investigated.
- o Review evidence of previously detected deficiencies and determine whether corrective action was taken.

4.11 The auditor of the primary recipient should obtain an understanding of the design of the government's system of 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 government's monitoring system in preventing or detecting subrecipients' noncompliance with the applicable rules and regulations.

4.12 The auditor tests the government's monitoring of subrecipients for federal financial assistance programs for which SOP 90-9 requires the auditor to test controls. The tests of controls may include a reperformance by the auditor of some or all of the procedures identified above as management responsibilities. The nature and extent of the tests performed will vary depending on the auditor's assessment of control risk and professional judgment. In general, the auditor's work is limited to those subrecipients that received over \$25,000 during the year. For other federal financial assistance programs, the auditor obtains an understanding of how the government monitors subrecipients.

4.13 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 each major federal financial assistance program of the recipient.

4.14 If subrecipient audits have not been made and the grant awards are material to programs administered by the recipient, the scope of the primary recipient's audit can be expanded by management to include testing of the subrecipient records. The scope of the audit of the recipient would be expanded to include the records of subrecipients by testing 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 reports on compliance with laws and regulations. In addition, a material weakness in internal controls may exist.

REPORTING ON COMPLIANCE

4.15 The auditor has different levels of reporting responsibility for compliance with laws and regulations that pertain to federal financial assistance programs. For major programs, the auditor is required to issue an opinion on whether the audited entity complied, in all material respects, with the specific requirements applicable to each major program. Conversely, auditors need only give limited assurances on the entity's compliance with general requirements and on the specific requirements applicable to any transactions selected from nonmajor programs. The limited assurance is positive concerning compliance for those items tested and negative for those items not tested. Auditors should be alert for possible instances of noncompliance of any of the compliance requirements throughout the engagement. If the auditors discover an instance of noncompliance, regardless of materiality, they should disclose the instance of noncompliance in their report on compliance.

4.16 The Compliance Supplement for Single Audits of State and Local Governments was revised in 1990 by the OMB to assist auditors in performing single audits and supplements OMB Circular A-128. The Compliance Supplement contains general compliance requirements that are national policies prescribed by statute, Executive Order, or other authoritative sources and that apply to the federal financial assistance programs of two or more federal agencies. It also contains compliance requirements specific to many of the larger federal financial assistance programs and suggests procedures for testing compliance with the specific requirements. The identified general and specific compliance requirements are those that the OMB and federal agencies have determined could have a material effect on a government's financial statements or an individual federal financial program. These compliance matters should be tested during the audit of federal financial assistance programs.

4.17 Besides describing these specific requirements, the Compliance Supplement includes references to the CFR and other sources of information about the requirements. When planning to test compliance with specific requirements, the auditor should consider referring to these other sources of information. The auditor should also be aware that compliance requirements may change over time and, accordingly, should inquire of management and cognizant federal agencies whether changes have occurred.

4.18 The Compliance Supplement does not contain the compliance requirements for all federal financial assistance programs. Auditors may also wish to look at the grant agreement. To assist in the audit of those programs not contained in the Compliance Supplement, the federal agencies responsible for them have developed supplemental compliance program guides. This additional guidance, where applicable, may be obtained from the government's cognizant agency.

4.19 The CFDA contains a description of all federal financial assistance programs. Programs not included in the Compliance Supplement may have specific requirements governing federal financial assistance. To obtain an understanding of these requirements, the auditor should consider referring to the CFDA. It is generally updated on an annual basis, with citations of laws and regulations applicable to included programs, and contains names of the program staff who serve as reference individuals for each program.

Specific Compliance Requirements

4.20 The auditor should obtain an understanding of the specific requirements applicable to the major federal financial assistance programs to help determine the nature, timing, and extent of procedures to be performed as a basis for expressing an opinion on compliance with those requirements. Specific requirements, if not complied with, may have a material effect on a federal financial assistance program and generally pertain to the following matters:

- o Types of services allowed or not allowed--specifies the types of goods or services entities may purchase with financial assistance
- o Eligibility--specifies the characteristics of individuals or groups to whom entities may give financial assistance
- o Matching, level of effort, or earmarking--specifies amounts entities should contribute from their own resources toward projects for which financial assistance is provided
- o Reporting--specifies reports entities must file in addition to those required by the general requirements
- o Special tests and provisions--other provisions for which federal agencies have determined noncompliance could materially affect the program (for example, some programs require recipients to hold public hearings on the proposed use of federal financial assistance; others set a deadline for the expenditure of federal financial assistance)

In addition, OMB Circular A-128 requires independent auditors to determine whether--

- o 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.
- o Amounts claimed or used for matching were determined in accordance with OMB Circular A-87, Cost Principles for State and Local Governments, and OMB Circular A-102, Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments.

These matters should be addressed in the auditor's opinion on major program compliance.

4.21 Although each requirement in the Compliance Supplement is accompanied by suggested audit procedures that can be used to test compliance with laws and regulations, those are not the only audit procedures that an auditor may use. The auditor should use professional judgment in determining the nature, timing, and extent of substantive tests of compliance with specific requirements. Among the matters the auditor considers are the results of tests of relevant internal control structure policies and procedures done in accordance with SOP 90-9.

MAJOR PROGRAM COMPLIANCE

4.22 To support the auditor's opinion on compliance with the specific requirements applicable to each major program, auditors are required to select a representative number of charges from each major program and test them for compliance with the specific requirements of that program. (Audit sampling is discussed later in this chapter.) The results of testing provide the basis for the auditor's opinion on compliance illustrated in example 18 of SOP 89-6. In determining the appropriate sample size, auditors should assess materiality in relation to the individual major program being tested. Materiality should not be measured in relation to major programs taken as a whole or 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. The level at which materiality is assessed is critical to determining the scope of the auditor's work and evaluating the results of audit procedures.

4.23 In determining whether to modify the opinion on compliance, the auditor should (a) assess the actual error noted against the materiality level established for the individual major program and (b) assess the projected error against the materiality level established for the individual major program.

4.24 If the auditor determines that the actual error is material to the individual program, the auditor's report should be modified as outlined in examples 19 through 22 of SOP 89-6, depending on the circumstances. 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.

4.25 Auditors also have the responsibility of assessing how the actual and projected error noted in the testing of the federal financial assistance programs affects the general-purpose financial statements.

4.26 As it does for the general requirements, the Compliance Supplement provides suggested audit procedures for testing compliance with the specific requirements. The results of such testing provide evidence to support the auditor's opinion on compliance.

NONMAJOR PROGRAM TESTING

4.27 The Single Audit Act requires transactions selected from federal assistance programs, other than major federal assistance programs, to be tested for compliance with federal laws and regulations that apply to such transactions. This requirement recognizes that, in connection with the audit of the financial statements or the consideration of the internal control structure over federal financial assistance programs, the auditor may have selected for testing transactions from federal financial assistance programs other than major programs. For example, selection of nonmajor program transactions may occur during an auditor's entitywide test of payroll or disbursement transactions. If the auditor has selected such transactions, they should be tested for compliance with the specific requirements that apply to the individual transactions. It is important to note that *nonmajor program* transactions generally will be selected, and thus nonmajor transaction testing

would be required whenever major programs do not equal or exceed 50 percent of total federal expenditures. If nonmajor program transactions are selected, they should be tested for compliance as discussed previously and reported on in accordance with example 24, "Single Audit Report on Compliance With Requirements Applicable to Nonmajor Federal Financial Assistance Program Transactions," of SOP 89-6.

4.28 In general, the requirements for which compliance should be tested relate to the allowableness of the program expenditure and the eligibility of the individuals or groups to whom the entity provides federal financial assistance, as shown in the following examples:

- o If in the audit of the general-purpose financial statements an auditor examined a payroll transaction that was charged to a nonmajor program, the auditor should determine that the position could reasonably be charged to that program and that the individual's salary was correctly charged to it. The auditor is not required to test for general compliance, such as compliance with the Hatch Act.
- o If, during the audit of the government's disbursements, the auditor examined a travel claim that was 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 allowances were within administratively prescribed limits. The auditor would not be required to test the transactions for general compliance, such as compliance with relocation or cash management limitations.
- o If the auditor examined a program-related payment made directly to an individual or organization, the auditor 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 for general compliance, such as civil rights and cash management.

General Compliance Requirements

4.29 The Compliance Supplement identifies the following nine requirements as general compliance requirements relating to individual programs:

1. Political activity (Hatch Act and Intergovernmental Personnel Act of 1970, as amended)
2. Davis-Bacon Act (construction contracts)
3. Civil rights
4. Cash management
5. Relocation assistance and real property acquisition
6. Federal financial reports

7. Drug-free workplace
8. Allowable costs/cost principles
9. Administrative requirements

Suggested audit procedures for testing compliance with these general requirements are included in the Compliance Supplement.

4.30 Political Activity. The Hatch Act and Intergovernmental Personnel Act of 1970, as amended, specify that federal funds cannot be used for partisan political activity of any kind by any person or organization involved in the administration of federally assisted programs.

4.31 Davis-Bacon Act. All construction programs are required to follow the provisions of this act, which in general requires the wages of laborers and mechanics employed by contractors of federally funded projects to be no lower than the prevailing regional wage rate as established by the secretary of labor.

4.32 Civil Rights. Federal aid programs provide that no person shall be excluded from participation in, 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.

4.33 Cash Management. Grantee financial management systems should include procedures to minimize the time elapsed between the transfer of funds from the U.S. Treasury and the disbursement of funds by the grantee. Many grantees 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. Advances made to a subrecipient should conform to these standards of timing and amount as if the funding was received directly from a federal agency.

4.34 Relocation Assistance and Real Property Acquisition. Federal aid programs may require the acquisition of property by a public agency and subsequent displacement of households and businesses. Grant recipients acquiring property in the administration of federal aid are required to carry out certain actions systematically (for example, have property appraised in the presence of the owner, review appraisals, set price, and negotiate settlements). Similarly, when displacements (relocations) are involved, the recipient should provide assistance systematically (for example, assure that replacement housing meets acceptable standards and maintain records on all acquisitions and displacements).

4.35 Federal Financial Reports. In connection with tests of compliance with applicable laws and regulations, OMB Circular A-128 states that "the auditor shall 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 general purpose or basic financial statements have been prepared."

4.36 The Common Rule discusses the required financial reports that apply to most of the federal financial assistance programs. These reports are as follows:

- o Financial Status Report (SF269)--reports status of funds for all nonconstruction programs.
- o Request for Advance or Reimbursement (SF270)--requests funds for nonconstruction programs when advance letter-of-credit or predetermined advance payments are not used.
- o Outlay Report and Request for Reimbursement for Construction Programs (SF271)--requests reimbursements and reports status of funds for construction programs.
- o Federal Cash Transactions (SF272)--reports cash transactions and balances for grantees receiving cash by a letter of credit or treasury check.

4.37 Treasury Circular 1075 lists two alternative cash management reports, one of which applies to each program financed through letters of credit. These reports are (a) Request for Payment on Letter of Credit and Status of Funds Report (SF183) and (b) Payment Voucher on Letter of Credit (TFS 5401).

4.38 Certain federal agencies have received OMB approval to adapt these reports or require other financial reports to meet their particular program needs. These additional reports would appear as specific requirements for the affected programs.

4.39 Regardless of their type and how frequently they are filed, federal financial reports play an important role for the granting agency. These reports provide the agency with important financial data concerning the program, and these data are necessary for monitoring the funds allocated to recipients and for planning for future funding. Consequently, the auditor should become familiar with the federal reports the recipient is required to file for each major program and review the reports for completeness and timeliness of submission.

4.40 Drug-Free Workplace. Beginning on March 18, 1989, all grantees receiving grants (including cooperative agreements) directly from any federal agency are required to certify that they will provide a drug-free workplace as a precondition of receiving a grant from a federal agency. All grantees, except for states, are required to make this certification for all grants they receive. States (including state agencies) may elect to make an annual certification to each federal agency from which it obtains financial assistance. This requirement also applies to contractors that have contracts of \$25,000 or more with the federal government. The requirement does not apply to pass-through assistance.

4.41 Allowable Costs/Cost Principles. OMB Circular A-87, Cost Principles for State and Local Governments, establishes principles and standards for determining costs applicable to grants, contracts, and other agreements. Costs are allowable for federal reimbursement only to the extent of the benefits received by the federal programs. To be eligible for federal reimbursement, costs (both direct and indirect) should meet the following nine basic criteria:

1. They should be reasonable and necessary for the proper and efficient performance and administration of the federal award(s).

2. They should be authorized or allowable under state or local laws and regulations.
3. They should conform to all limitations or exclusions established by OMB Circular A-87, federal laws, or other governing limitations as to types, amounts of costs, or both.
4. They should be consistent with the policies, regulations, and procedures that apply uniformly to both federally assisted and other activities of the governmental unit.
5. They 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 allocation plan.
6. They should be determined in accordance with generally accepted accounting principles appropriate for the circumstances.
7. They should not be included as a cost or used to meet the cost-sharing or matching requirements of any other federally supported activity in either the current or a prior period.
8. They should be net of all applicable credits.
9. They should be adequately documented.

4.42 In addition to federal reimbursement for direct program costs, a government may get reimbursement for indirect costs or centralized services. To obtain reimbursement, governments should establish a basis for allocating indirect costs to federal programs by preparing a cost allocation plan, an indirect cost proposal, or both. Each government for which the OMB has identified a federal cognizant agency, as well as any unidentified organization specifically requested to do so, should submit its cost allocation plan or indirect cost rate proposals to the cognizant agency for approval. Other unlisted organizations that have prepared plans or proposals may use their results, but are to maintain them on file for later review.

4.43 The transactions selected by the auditor should be reviewed to determine whether the costs meet the criteria of OMB Circular A-87. The auditor's working papers should document the applicable criteria reviewed, the results of the procedures performed, and the conclusion reached by the auditor.

4.44 Administrative Requirements. The Common Rule contains various administrative requirements with which state and local governments need to comply. The Common Rule requirements apply to federal assistance in the form 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.

4.45 Three administrative requirements--cash management, financial reporting, and cost principles--are explicitly included among the general requirements. The Compliance Supplement tells auditors to consider certain of the other administrative requirements, from subpart C of the Common Rule. Practice

seems to indicate that the following administrative requirements could have a material effect on the federal financial assistance programs and should, therefore, be included among the general requirements addressed in an audit of federal financial assistance: (a) program income, (b) procurement, and (c) subgrants. The auditor should exercise professional judgment in determining if other administrative requirements are relevant in an audit of federal financial assistance.

TESTING GENERAL REQUIREMENTS

4.46 When performing an audit in accordance with the Single Audit Act, the auditor should perform audit procedures relative to the nine general requirements. To support the report on the entity's compliance with general requirements, the auditor should select and test compliance with the general requirements applicable to each major federal financial assistance program. In situations in which major programs do not exist or major program expenditures do not constitute at least 50 percent of the total federal expenditures, the auditor should test compliance with the general requirements related to the nonmajor programs included in the understanding and assessment of the internal control structure over those federal financial assistance programs, as discussed in SOP 90-9. 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.

4.47 The Compliance Supplement includes suggested procedures that can be performed to test the entity's compliance with the general requirements; however, the use of the Compliance Supplement is only recommended, not required. Performing these procedures allows the auditor to provide positive assurance on the requirements tested for compliance and negative assurance for items not tested. As the Single Audit Act has been implemented, it has become generally accepted that the nature of these procedures is sufficient to satisfy the requirements of the Act with respect to the general requirements. However, the Compliance Supplement does not specify the extent of these procedures for testing compliance with the general requirements, and the auditor may wish to obtain an understanding with the client about the extent of such procedures. Among the matters the auditor should consider are the results of any tests of controls performed in accordance with SOP 90-9.

4.48 The auditor should select appropriate procedures and perform tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures relative to general 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 (that is, whether the understanding or results indicate the existence of any reportable conditions or material weaknesses). The steps performed and conclusions reached should be clearly shown in the auditor's working papers. The results of the tests of controls may allow the auditor to reduce the amount of substantive testing of compliance with laws and regulations. If the auditor plans such a test as a dual-purpose test (that is, one that is designed to meet the objectives of both a test of controls and a substantive test of the requirement), this test may be sufficient to support the issuance of a report on the general compliance requirements related to those nonmajor programs. The amount of substantive tests performed should be sufficient to support the

auditor's statements of positive assurance on the entity's compliance with the general requirements.

4.49 Many entities receive federal financial assistance from several federal agencies and, consequently, develop uniform controls and procedures over all federal programs. With regard to general requirements, however, many entities do not formally document their administrative controls and procedures. To identify the established controls and procedures for these requirements, the auditor will normally make inquiries of key personnel of the entity, including grant managers. The auditor may also identify these controls and procedures by reviewing policy and procedure manuals, if any, and by observing the general workplace of the entity. The auditor may develop a uniform understanding of the controls over the general program requirements and document the system as a whole.

CLIENT REPRESENTATIONS

4.50 GAAS requires the auditor to obtain written representations from management. For single audits, those representations should include not only management's representations concerning the identification and completeness of federal financial assistance received, as included in the Supplementary Schedule of Federal Financial Assistance, but also representations concerning management's compliance with applicable laws and regulations. Management's representations should include identification of known instances of noncompliance. SAS No. 63 states that the following representations should be obtained from management when a single audit is performed:

- o Management has identified in the schedule of federal financial assistance all assistance provided by federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations.
- o 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, and drug-free workplace, as well as administrative requirements over federal financial assistance.
- o Management has identified the requirements governing the types of services allowed: eligibility; matching, level of effort, or earmarking; reporting (include any special provisions); claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the schedule of federal financial assistance.
- o Management has complied with reporting requirements in connection with federal financial assistance.
- o 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.

- o Amounts claimed or used for matching were determined in accordance with OMB Circular A-87, Cost Principles for State and Local Governments, and with the Common Rule.
- o Management has monitored subrecipients to determine whether the subrecipients have expended financial assistance in accordance with applicable laws and regulations and have met the requirements of OMB Circular A-128 or OMB Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Organizations, whichever is applicable.
- o 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.
- o Management has considered the results of subrecipients' audits and made any necessary adjustments to the entity's own books and records.
- o Management has identified and disclosed to the auditor all amounts questioned and known noncompliance with requirements if such noncompliance could have a material effect on a major federal financial assistance program.

AUDIT SAMPLING FOR MAJOR FEDERAL FINANCIAL ASSISTANCE PROGRAMS

4.51 Although the Single Audit Act does not require statistical sampling, it does require that a "representative number of transactions be selected from each major federal financial assistance program." Auditors should use professional judgment in determining methods of sample selection and should be certain that the size of the sample for major programs is sufficient to allow the auditor to express an opinion on compliance with applicable laws and regulations relative to the major programs.

4.52 The objectives of auditing procedures for federal financial assistance are to provide evidential matter that is sufficient and competent to provide reasonable assurance of detecting material noncompliance with "specific requirements" applicable to major federal financial assistance programs and issue a report containing either an opinion on compliance with these requirements or a statement that such an opinion cannot be expressed. The auditor should keep these basic objectives in mind when selecting the sample sizes to be used in testing each major program. Based on the auditor's assessment of control risk, the auditor should select sample sizes that will supply him or her with sufficient evidence to enable him or her to draw a conclusion as to the government's compliance with the specific requirements applicable to each major program. The auditor's professional judgment should be used when selecting sample sizes. However, when exercising that judgment, the auditor should be aware that small samples of only two or three items with a low dollar value from a large population may not necessarily be sufficient to enable the auditor to formulate a conclusion concerning compliance.

4.53 The Single Audit Act requires that a representative number of transactions be selected from each major program but does not require that separate samples be used for each major program. Practice has shown, however, that it is generally preferable to select separate samples from each major

program, since the separate sample clearly provides evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate (a) that a representative number was selected from each major program and (b) that the results of tests of such samples, together with other audit evidence, is sufficient to support the opinion on major program compliance and such numbers support the auditor's opinion on each major program.

NONMAJOR TRANSACTIONS

4.54 The auditor should also review samples selected during tests of the internal control structure and the audit of the general-purpose financial statements to identify nonmajor program transactions that will require further compliance testing under the provisions of the Single Audit Act. See paragraphs 4.27 and 4.28 for additional guidance.

CHAPTER 5

REPORTING UNDER THE SINGLE AUDIT ACT

INTRODUCTION

5.1 Audits of federal financial assistance expand the level of auditor responsibility from strictly reporting on an entity's financial results to reporting on its internal control structure and compliance with laws and regulations. To fulfill this increased responsibility, additional audit reports need to be issued. Exhibit 5.1 displays the levels of reporting and different reports that are required for meeting the provisions of the Single Audit Act. Examples of how standard reports, such as those provided in SOP 89-6, can be modified appear in appendix D.

REPORTING

5.2 The reporting responsibility is driven by the three levels of auditing standards that may be followed: GAAS, Government Auditing Standards, and the Single Audit Act.

REQUIRED AUDITORS' REPORTS

5.3 Exhibit 5.1 depicts the various auditor reports required for compliance with the Single Audit Act. Auditors need to understand the intended purpose of each report and should tailor the reports to their specific audit situation. Many of the standard reports can be found in SOP 89-6 and SOP 90-9. Modifications to the standard reports for circumstances such as uncertainty are presented in appendix D.

Report on General-Purpose Financial Statements

5.4 GAAS requires auditors to report on whether the governmental entity's general-purpose financial statements (GPFS) are presented fairly in accordance with GAAP. The GPFS provide the funding agency with an understanding of the entity's accounting policies and procedures. When assessing whether GPFS 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 responsibilities for consideration of laws and regulations and how they affect the audit are described in SAS Nos. 54 and 63.

5.5 In performing an audit of an entity's GPFS in accordance with Government Auditing Standards, the auditor assumes, among other things, reporting responsibilities beyond those in an audit in accordance with GAAS. In addition to the report on whether the governmental entity's GPFS are fairly presented, the auditor is required to issue a report on compliance with laws and regulations and a report on the entity's internal control structure, as described in SAS No. 63.

EXHIBIT 5.1

GOVERNMENT REPORTING MATRIX

<u>Report</u>	<i>Government Auditing Standards Audits</i>	<u>Single Audits</u>		
		<u>Major and Nonmajor Programs</u>	<u>Major Programs Only</u>	<u>Nonmajor Programs Only</u>
GPFS	1-15 ^a	1-15 ^a	1-15 ^a	1-15 ^a
Internal control structure at GPFS level	25 ^a	25 ^a	25 ^a	25 ^a
Compliance at GPFS level	17 ^a	17 ^a	17 ^a	17 ^a
Supplementary schedule of federal financial assistance	N/A	16 ^a	16 ^a	16 ^a
Internal control structure at federal program level	N/A	SOP 90-9 ^c	SOP 90-9	SOP 90-9 ^c
Specific compliance at federal program level	N/A	18-22 ^a and 24 ^c	18-22 ^a	24 ^c
General compliance at federal program level	N/A	d	d	d
Management letter	b	b	b	b
Report on illegal acts	b	b	b	b

^aNumbers refer to examples in SOP 89-6. All reports should be tailored to individual circumstances.

^bThese items may need to be issued if applicable.

^cMajor program expenditures constitute less than 50 percent of total federal expenditures.

^dSee appendix D, example 2.

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

5.6 Government Auditing Standards requires auditors to report on compliance with laws and regulations that, if violated, could have a material impact on the entity's financial statements. SOP 89-6, example 17, illustrates the standard language for such a report.

Report on the Internal Control Structure Required by Government Auditing Standards

5.7 In order for auditors to issue this internal control structure report, the level of audit work outlined in SAS No. 55 needs to be completed. The report does not express an opinion on the government's internal control structure, but rather describes the extent of work performed to comply with SAS No. 55. The report presents the requirements of SAS No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit, as well as the additional requirements of Government Auditing Standards. These additional requirements include the identification of significant internal control structure categories and a description of the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk. The report should also include a description of deficiencies in internal control structure considered to be reportable conditions as well as separately identifying those reportable conditions that are considered material weaknesses. An example of standard reporting language is presented in SOP 89-6, example 25.

5.8 As stated previously, this report on the internal control structure should identify the significant internal control structure categories involved in the processing of information presented in the GPFs. Page 5-8 of Government Auditing Standards emphasizes that these controls include the control structures established to ensure compliance with laws and regulations that could have a direct and material effect on the financial statements and that such controls may include the controls over the general and specific compliance requirements relative to federal financial assistance programs.

5.9 Although it may not be appropriate in all circumstances to include the general and specific controls in the report, auditors need to consider these controls for inclusion. Inclusion should be based on the auditor's judgment about whether noncompliance with a general or specific requirement could result in a material error in the financial statements.

5.10 Because Government Auditing Standards reports on compliance and internal control structure are "financial statement level" reports, adherence to GAAS and Government Auditing Standards is necessary for supporting the issuance of these reports. This means that in addition to complying with GAAS, the auditors need to comply with additive standards of Government Auditing Standards such as continuing professional education and quality control standards.

5.11 Auditors performing audits under the Single Audit Act are required to follow GAAS and Government Auditing Standards and thus need to report on the entity's GPFs, compliance with laws and regulations, and internal control structure as described previously. In addition to these responsibilities, the auditor is required to report on the Supplementary Schedule of Federal

Financial Assistance, the entity's internal control structure over federal financial assistance programs and its compliance with laws and regulations related to federal financial assistance programs.

Report on Supplementary Schedule of Federal Financial Assistance

5.12 This report, required to be issued by OMB Circular A-128, makes specific reference to the audit having been performed in accordance with Government Auditing Standards and provides an opinion on the fair presentation of the Schedule "in relation to" the general-purpose financial statements. An illustration of this is provided in SOP 89-6, example 16.

Report on Internal Control Structure Over Federal Financial Assistance Programs

5.13 This report covers internal control structure policies and procedures used in administering federal financial assistance programs in compliance with laws and regulations. SOP 90-9 provides guidance on applying the concepts of SAS No. 55 to federal programs and illustrates the report that is issued when the additional internal control work required by the Single Audit Act is performed.

Single Audit Opinion on Compliance With Specific Requirements Applicable to Major Federal Financial Assistance Programs

5.14 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 noncompliance occurred, could materially affect each major program. Examples 18 through 22 of SOP 89-6 illustrate various reports that can be issued based on the results of the compliance testing of specific requirements of major federal financial assistance programs. An illustrative report for situations in which uncertainties about compliance exist is included in appendix D. The report identifies the major 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. 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.

Single Audit Report on Compliance With the General Requirements Applicable to Federal Financial Assistance Programs

5.15 Example 2 of appendix D supersedes example 23 of SOP 89-6 and illustrates the report to be issued when testing of general requirements for federal financial assistance programs has been performed. The report cites the general requirements tested and the procedures performed and expresses positive assurance with respect to items tested and negative assurance with respect to items not tested.

Single Audit Report on Compliance With Requirements Applicable to Nonmajor Federal Financial Assistance Programs

5.16 Example 24 of SOP 89-6 illustrates the report to be issued with regard to any transactions from nonmajor federal financial assistance programs selected during tests performed in connection with the GPFS and the review of the internal control structure used to administer federal financial assistance programs. The auditor is required to substantively test the selected items for allowability and eligibility, make any special tests and provisions, and express positive assurance on items tested and negative assurance on items not tested. This report would be issued when nonmajor transactions are tested to satisfy the requirements of the 50-percent rule as described in SOP 90-9.

5.17 Other correspondence that may need to be issued includes--

- o Verbal or written correspondence with management pertaining to nonreportable conditions or other matters involving the internal control structure. If written, the letter should be referred to in the two reports on the internal control structure.
- o A written report on fraud, abuse, or an illegal act or on indications of such acts, when discovered.

DATING OF REPORTS

5.18 Since the report on the Schedule indicates that the auditor is giving an opinion "in relation to" the GPFS, it should carry the same date as the report on the GPFS. Furthermore, since the reports on compliance and internal control structure related to the GPFS (that is, Government Auditing Standards reports) can directly impact the GPFS, they should bear the same date as the report on the GPFS.

5.19 Ideally, the reports required by the Act should also be dated the same as the other reports, but they often carry a later date because the audit work to satisfy the single audit requirements may be done subsequent to the work on the GPFS. The risk the auditor bears by performing the single audit procedures at a later date is that compliance deviations might be discovered that could materially affect the GPFS. In such cases the auditor should follow the guidance in AICPA Professional Standards, volume 1, AU sections 560 and 561.

RELIANCE ON OTHER AUDITORS

5.20 When more than one independent auditor is involved in an audit performed under the Single Audit Act, guidance regarding an opinion or financial statements based in part on the report of another auditor is presented in SAS No. 58, Reports on Audited Financial Statements, paragraphs 12 and 13. An example of a report on the GPFS with reference to the audit of a component unit or fund by another auditor is provided in examples 12 and 13 of SOP 89-6.

DISTRIBUTION OF REPORTS

5.21 The audited entity is responsible for submitting copies of reports to each federal department or agency that provides federal financial assistance to it. In addition, the recipient is responsible for submitting a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings. Each agency may specify in its program regulations or in the award the distribution point for the single audit reports. Recipients of \$100,000 or more in federal funds shall submit a copy of the audit report within thirty days after issuance to the central audit report clearinghouse, which is located at the following address:

Bureau of the Census
Data Preparation Division
1201 E 10th Street
Jeffersonville, Indiana 47132

Subrecipients shall also submit copies to recipients that provided them with federal financial assistance funds.

5.22 Single audit reports are due no later than thirteen months following the end of the entity's fiscal year. Twelve months are for the preparation of the audit report. The thirteenth month is for audit transmittal.

5.23 Although the required auditors' reports may be issued simultaneously to the recipient, such delivery may not be practicable and the auditor should consider this when planning the audit. If simultaneous delivery is not possible, the auditor could deliver the report on the entity's financial statements and separately deliver the balance of the reports as one bound report. Separate delivery of each or part of the balance of the reports is not recommended because this may cause confusion, which, in turn, may result in the full complement of reports not being delivered to grantors.

5.24 OMB Circular A-128 requires the following:

- o The reports shall be made available by the state or local government for public inspection within thirty days after completion of the audit and issuance of the audit reports by the auditor to the recipient government audit.
- o Reports shall be submitted by the auditor to the recipient government audited and to those requiring or arranging for the audit. In addition, the recipient shall submit copies of the report to each federal department or agency that provides federal assistance funds to the recipient. Subrecipients shall submit copies to recipients that provided them federal financial assistance funds. The reports shall be sent to federal grantors within thirty days after the completion of the audit and issuance of the audit reports by the auditor, but no later than one year after the end of the audit period, unless a longer period is agreed to with the cognizant agency.

5.25 If separate auditors' reports constitute the single audit reporting package, the thirty-day provision generally means thirty days following the date that appears on the transmittal of the last required auditors' report received by the recipient.

COMPLIANCE TESTING AND REPORTING ON UNCERTAINTY

5.26 Guidance on the auditor's responsibility for testing and reporting on compliance with laws and regulations is contained in SAS No. 63.

5.27 SAS No. 63 describes the auditor's responsibility when the auditor is testing and reporting on such compliance and indicates that these responsibilities vary depending on the auditing standards followed. The three levels of auditing standards addressed in the Statement are (a) GAAS, (b) Government Auditing Standards, and (c) the Single Audit Act. Although testing compliance with certain laws and regulations is required regardless of which standards are followed, reporting on compliance is only required when auditing in accordance with Government Auditing Standards and the Single Audit Act. GAAS does not require a report to be issued.

Government Auditing Standards Audits

5.28 In both GAAS and Government Auditing Standards financial statement audits, testing for compliance with laws and regulations focuses on those federal, state, and local laws and regulations that are generally recognized by auditors as having a direct and material effect on the determination of financial statement amounts.

5.29 The auditor performs various audit procedures as the basis for forming a conclusion about whether an entity complied in all material respects with such laws and regulations. However, these procedures do not always allow the auditor to form a conclusion about the impact that may result from noncompliance with those laws and regulations.

5.30 For GAAS and Government Auditing Standards audits, the effects of any violations or possible violations of laws or regulations found as a result of the auditor's procedures should be considered for disclosure in the footnotes to the financial statements or as a basis for recording a loss contingency, as provided for in Financial Accounting Standards Board (FASB) Statement No. 5, Accounting for Contingencies. If disclosure is not made or a loss is not recorded, the auditor should consider modifying the audit report on the financial statements (that is, "except for" or uncertainty language--see SAS No. 58 for guidance). In addition, violations of laws or regulations may be considered an illegal act. Illegal acts are discussed in detail in chapter 6.

5.31 However, if the auditor cannot examine sufficient evidence to determine whether compliance with applicable laws and regulations exists, a scope limitation exists and the auditor's report on the financial statements would be modified accordingly.

5.32 Many situations exist in which procedures performed by the auditor, though providing sufficient evidence for determining if compliance exists, may not provide sufficient evidence for determining the impact of noncompliance. However, Government Auditing Standards requires a compliance report to be

issued regardless of whether the financial impact of the noncompliance is fully known, and accordingly, the standard report (that is, example 17 of SOP 89-6) would need to be modified to reflect the results of the audit procedures. For example, if the auditor believes an instance of noncompliance has occurred and is material to the financial statements, the guidance and example audit report in paragraphs 24 through 27 of SAS No. 63 should be followed. However, if noncompliance has occurred but the impact of noncompliance cannot reasonably be determined, the guidance relating to uncertainties in paragraphs 23 through 26 of SAS No. 58 should be used as a basis for modifying the compliance report. An example of such a report is provided in appendix D, example 1.

Single Audits

5.33 When performing single audits, reporting on compliance with the general and specific compliance requirements of an entity's federal programs is required. As part of this reporting responsibility, auditors need to consider the impact of instances of noncompliance at two levels of materiality. First, instances of noncompliance with program requirements need to be judged in light of the materiality level established for the applicable program; that is, the materiality of known and projected instances of noncompliance must be assessed relative to the affected program to determine if an audit report modification is necessary. Second, if the affected program is material to the overall financial statements being audited, the impact of the known and projected instances of noncompliance should be considered when reporting on those financial statements as a whole; that is, the impact of the instances of noncompliance must be considered relative to the materiality level set for the combined or individual fund financial statements being reported on. (It should be noted that several instances of noncompliance that may not be individually material at either level need to be considered if, in the aggregate, they could have a material effect.)

5.34 Testing an entity's compliance with general and specific compliance requirements requires auditors to make a comply/noncomply decision about an entity's adherence to those laws and regulations. OMB Circular A-128 requires that any instances of noncompliance that result from these tests of compliance be reported regardless of the ultimate outcome of the violation. If a comply/noncomply decision cannot be made, a scope limitation would exist, not an uncertainty. Only when an instance of noncompliance actually occurred and the ramifications are not known would an uncertainty exist. The following reporting scenarios could occur when the auditor is reporting on the results of compliance testing:

1. If appropriate evidence cannot be examined to support the comply/noncomply decision, a scope limitation would exist and the audit report would need to be modified. (For an example of such a report on major programs, see SOP 89-6, example 19.) However, if the auditor concludes that compliance with a requirement is not capable of reasonably consistent estimation or measurement, the auditor would be precluded from issuing an opinion on compliance with a specific requirement (SOP 89-6, example 20).

2. If the auditor examined sufficient evidence to support a noncompliance finding, a modification to the auditor's report on compliance should be considered in light of several factors, including number and type of instances of noncompliance, determinability of questioned costs, and materiality of questioned costs. If, after considering these factors, the auditor--
 - o Believes the instance of noncompliance has a material effect on a federal program, the auditor's report should be modified--qualified or adverse (SOP 89-6, examples 21 and 22).
 - o Cannot determine whether the instance of noncompliance could have a material effect on the program, an uncertainty exists. Accordingly, the report on compliance should state that noncompliance occurred but that the effect on the federal assistance program cannot presently be determined (see appendix D, example 5). The auditor also should consider the impact of uncertainties associated with federal programs on the general-purpose financial statements and modify that report if necessary.

FINDINGS AND QUESTIONED COSTS

5.35 OMB Circular A-128 requires that the auditor's report on compliance contain a summary of all findings of noncompliance and an identification of total amounts questioned, if any, for each federal financial assistance award as a result of noncompliance. Auditors should not exclude findings from their reports if those findings are immaterial. For example, the auditor may conclude that a finding related to the late filing of quarterly financial status reports would not have a material effect on the entity's financial statements or the Supplementary Schedule of Federal Financial Assistance. However, because the auditor should report all noncompliance findings, the instance of noncompliance described would be reported.

WHAT SHOULD BE REPORTED

5.36 In an audit of federal financial assistance in accordance with the Single Audit Act, findings are instances of noncompliance with general or specific requirements applicable to federal financial assistance programs. All instances of noncompliance with these requirements should be identified in the schedule of findings and questioned costs.

5.37 The auditor should also report all questioned costs related to federal financial assistance programs: The term questioned costs is defined in the Inspector General Act Amendments of 1988 as (a) an alleged violation of a provision of 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 is not supported by adequate documentation, or (c) a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable.

CRITERIA FOR REPORTING QUESTIONED COSTS

5.38 The criteria established for determining or questioning costs 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, such as OMB Circular A-87. In general, the criteria for determining and reporting questioned costs relate to the following:

- o Unallowable costs--certain costs specifically unallowable under the general and special award conditions or agency instructions (including, but not limited to, pregnant and postgrant costs and costs in excess of the approved grant budget either by category or in total)
- o Undocumented costs--costs charged to the grant for which adequate detailed documentation does not exist (for example, documentation demonstrating their relationship to the grant or the amounts involved)
- o Unapproved costs--costs that are not provided for in the approved grant budget, or for which the grant or contract provisions or applicable cost principles require the awarding agency's approval, but for which the auditor finds no evidence of approval
- o Unreasonable costs--costs incurred that may not reflect the actions that a prudent person would take in the circumstances, or costs resulting from assigning an unreasonably high valuation to in-kind contributions

5.39 The Single Audit Act and OMB Circular A-128 do not require that the auditor's report on compliance include a projection of questioned costs to the universe of federal financial assistance programs, nor do they require that the auditor expand the scope of an audit to determine with greater precision the effect of any questioned cost. However, there may be some instances in which the circumstances of specific questioned costs could be the 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. If the recipient has not recorded or disclosed a liability or contingent liability for such refunds, the auditor should consider the effect of the liability or contingent liability on the general-purpose financial statements. FASB Statement No. 5, as amended and interpreted, provides guidance on accruing and disclosing contingent liabilities.

5.40 Once identified, management is responsible for directing the corrective action and resolving recommendations associated with findings and questioned costs. However, Government Auditing Standards requires the auditor to report on the current status of significant or material known findings that were noted in prior audits and that could affect current audit objectives.

5.41 Noncompliance that does not involve federal financial assistance (such as violations of state or local laws) and that may be noted during the financial statement audit should not be included in the schedule of findings and questioned costs. Rather, those instances of noncompliance should be reported in accordance with paragraphs 24 through 29 of SAS No. 63.

5.42 Reportable conditions and material weaknesses in internal controls over federal financial assistance may be closely related to noncompliance and questioned costs. To clarify the relationship between internal control and compliance findings, it may be effective to include reportable conditions and material weaknesses in the schedule of findings and questioned costs. If the auditor presents reportable conditions and material weaknesses in the schedule of findings and questioned costs, then the report on internal controls over federal financial assistance may refer to that schedule rather than repeat the findings. Reportable conditions and material weaknesses not related to federal financial assistance should be presented in the auditor's report on the internal control structure, not in the schedule of findings and questioned costs.

HOW TO PREPARE THE SCHEDULE OF FINDINGS AND QUESTIONED COSTS

5.43 The schedule of findings and questioned costs should be prepared in accordance with relevant reporting standards contained in Government Auditing Standards. Those standards address elements of audit findings and place findings, and other report presentation matters, in the proper perspective.

5.44 The auditor's schedule of findings and questioned costs should contain a summary of all instances (findings) of noncompliance and should identify total amounts questioned, if any, for each federal financial assistance program. Government Auditing Standards suggests that well-developed findings--which provide sufficient information to federal, state, and local officials to permit timely and proper corrective action--generally consist of statements of the condition (what is), criteria (what should be), effect (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. In reporting noncompliance, auditors should place their findings in proper perspective. The extent of noncompliance should be related to the number of cases examined and the dollar amount questioned in order to give the reader a basis for judging the prevalence of noncompliance. Government Auditing Standards also requires that auditors report the status of uncorrected material findings that are from prior audits and that affect current audit objectives.

5.45 Some cognizant agencies have requested auditors to list the number and dollar amounts of items tested and the total universe, even though this is not required. The use of a table may be appropriate to summarize extensive findings.

5.46 Government Auditing Standards requires the auditor's findings to include views of responsible client officials, as appropriate. In an audit of federal financial assistance in accordance with the Single Audit Act, however, it generally would not be necessary to present client views in the auditor's report. The Single Audit Act requires management to submit to appropriate federal officials a plan for corrective action to remedy any material

weaknesses in internal controls or material instances of noncompliance found during the audit. Thus, when the auditor identifies material weaknesses or material instances of noncompliance, management will provide comments on those findings directly to federal officials.

5.47 In preparing a schedule of findings and questioned costs that will meet the needs of its users, the auditor should consider the following guidelines:

- o The findings should be organized so that they can be readily related back to the Supplementary Schedule of Federal Financial Assistance.
- o Those findings that produce questioned costs should be explained fully enough that the program manager can determine the relative magnitude of the finding.
- o The findings should be described completely and clearly so that the program manager can readily understand the nature of and reason for the noncompliance.
- o Current-year findings should be distinguished from the discussion of the status of prior-year findings.
- o The status of uncorrected prior-year findings should be discussed.
- o If appropriate, the schedule may refer to reports of other auditors or of federal inspectors general that present material findings.

5.48 A schedule of findings and questioned costs prepared in accordance with the criteria described in this chapter could be organized as follows:

I. Material Findings and Questioned Costs

Program (by CFDA number)

1. Finding
 - a. Condition
 - b. Criteria
 - c. Effect
 - d. Cause
2. Questioned cost

II. Immaterial Findings and Questioned Costs

Program (by CFDA number)

1. Finding
 - a. Condition
 - b. Criteria
 - c. Effect
 - d. Cause
2. Questioned cost

III. Status of Prior-Year Findings

IV. Reference to Material Findings Presented in Reports of Other Auditors or Federal Inspectors General

CHAPTER 6

FINANCIAL STATEMENT AUDIT CONSIDERATIONS

6.1 The financial statement audit is performed in accordance with Government Auditing Standards, issued by the Comptroller General of the United States, and results in a report on the financial statements. The primary sources of guidance and standards on auditing the financial statements of state and local governments are the AICPA Audit and Accounting Guide Audits of State and Local Governmental Units and the Statements on Auditing Standards issued after the guide was published (SAS Nos. 50 through 63). This chapter provides additional guidance on two financial statement audit considerations: (a) the applicability of GAAP to government financial statements and (b) compliance with laws and regulations.

APPLICABILITY OF GAAP

6.2 The Single Audit Act and OMB Circular A-128 require the auditor to express an opinion on whether the financial statements of the governmental unit as a whole are fairly presented in conformity with GAAP. However, for various reasons (such as legal or regulatory requirements), some state and local governmental units prepare their financial statements on a basis of accounting other than GAAP (for example, cash-basis). If financial statements are prepared on a comprehensive basis of accounting other than GAAP, the auditor's report should be prepared in accordance with SAS No. 62, Special Reports, which requires the report to (a) state or refer to a note to the financial statements that states the basis of presentation and (b) state that the basis of accounting is a comprehensive basis of accounting other than GAAP. Consideration should be given to presenting the financial statements in accordance with GAAP and issuing cash-basis statements as supplementary information to satisfy the entity's legal requirements.

COMPLIANCE WITH LAWS AND REGULATIONS

6.3 Governmental entities, because they are established by and operate under numerous laws and regulations, are subject to many more legal constraints than are their nongovernmental counterparts. Accordingly, auditors of government entities typically need to be aware of the existence of many more laws and regulations in planning and executing a government audit than in planning and executing a commercial audit. As discussed in SAS No. 63, the auditor's responsibility varies with respect to detecting and reporting noncompliance with laws and regulations. The extent of the auditor's responsibility is influenced by--

- o The existence of compliance auditing requirements mandated by a state government.
- o The effect of laws and regulations on the determination of financial statement amounts (that is, direct or indirect).

- o The reporting requirements of Government Auditing Standards.

State Compliance Audit Requirements

6.4 Some states have adopted rules governing the performance of compliance audits that clearly define the auditing and reporting expectations for audits of local governmental units.

6.5 Examples of such audit requirements may be found in Florida, which has adopted rules for audits of local governmental units, making the provisions of Government Auditing Standards applicable to all phases of audits of those governmental units. The Florida law and implementing rules also require annual full-compliance audits of each qualifying governmental unit and provide that all instances of noncompliance discovered within the course of the audit be reported. Similarly, other states have adopted statutes relating to audit scope and compliance auditing.

6.6 The adoption of specific compliance auditing requirements by state and local jurisdictions makes it imperative that auditors review whether management has identified the specific compliance matters, as well as the related criteria for determining compliance, to be addressed within the scope of those audits. Subject matter often covered by laws and regulations that affect governmental entities include the following:

- o Arbitrage--Calculate, report, and rebate arbitrage earnings or penalties to the federal government.
- o Tax reporting--Report salaries (W-2), taxable fringe benefits, and other income (1099) in accordance with federal and state requirements.
- o Funds--Establish funds required by law, regulation, or bond covenant.
- o Procurement--Contract or make procurement through competitive bidding or negotiation.
- o Appropriations--Expend funds within authorized limits.
- o Debt limitations--Contract debt within limits imposed by state or local laws.
- o Tax limitations--Comply with constitutional or statutory property tax rate limitations and tax increase requirements.
- o Investments--Invest in accordance with state or local laws or regulations.
- o Reporting entity--Prescribe those components of the reporting entity that may not comply with GAAP.
- o Budget reporting--Budget and report budgetary information on a basis of accounting other than GAAP.

6.7 For these and other compliance matters within the scope of the audit, the auditor should seek guidance from affected local officials, state officials with oversight responsibility, and appropriate legal counsel. Failure to properly evaluate whether transactions were executed without clear legal authority may serve to conceal significant financial exposures of the audited governmental unit.

6.8 The U.S. General Accounting Office, Office of Policy, has published a guide entitled Assessing Compliance With Applicable Laws and Regulations (December 1989). This guide addresses the identification of applicable laws and regulations in determining the extent of compliance testing. Auditors may wish to refer to this document for guidance. It can be obtained from the U.S. General Accounting Office, Post Office Box 6015, Gaithersburg, Maryland 20877.

Illegal Acts--Direct and Material

6.9 When performing an audit in accordance with GAAS, auditors should consider the federal, state, and local laws and regulations that are generally recognized to have a direct and material effect on the determination of financial statement amounts.

6.10 A consideration of such laws and regulations entails gaining an understanding of what laws and regulations may have a direct and material effect on the determination of financial statement amounts and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement.

6.11 It is management's responsibility to identify the compliance requirements of the government. The auditor should discuss these requirements with the government's chief financial officer and, if necessary, legal staff. Discussions with these officials should focus on those compliance matters included in the laws and regulations (including the government's charter and financial ordinances) that may require testing. Where appropriate, contact should be made with the state auditor or a similar oversight organization to obtain its perspective on key compliance areas 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 Department of the Treasury, Internal Revenue Service, requirements pertaining to information returns and regulations concerning arbitrage rebate calculation and refund.
- o Review materials available from other professional organizations, such as state societies of CPAs.
- o Identify sources of revenue received by the entity and inquire about restrictions, limitations, terms, and conditions under which such revenue is received. Review any directly related agreements (for example, loans and grants) and inquire about the applicability of any overall regulations of senior governments to the revenue or accounting for the revenue.

- o Obtain copies, and review those sections, of the state constitution and state laws that are relevant to the governmental entity. The sections of these documents pertaining to debt, taxation, budget, and appropriation and procurement matters are especially relevant.
- o Consider contacting the audit, finance, or program divisions of those senior levels of government from which grants are received. They usually can be helpful in identifying compliance requirements and may identify compliance requirements separately or in a published audit guide.

6.12 Once the auditor has obtained an understanding of the laws and regulations to which the government is subject, he or she should begin to assess the risk of noncompliance. To assess this risk, the auditor should obtain an understanding of the characteristics of noncompliance with identified laws or regulations. Such characteristics may include materiality of the effect on financial statement amounts, level of management or employee involved in the compliance-assurance process, opportunity for concealment of noncompliance, internal control structure weakness, and the effect of noncompliance on the financial statements.

6.13 To assess risk of noncompliance, the auditor should also obtain an understanding of the internal control structure designed to ensure compliance with identified laws and regulations.

6.14 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 would be considered material to the financial statements. In all circumstances, the auditor should exercise (a) due care in planning, performing, and evaluating the results of audit procedures and (b) the proper degree of professional skepticism to achieve reasonable assurance that direct and material illegal acts will be detected.

6.15 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 does not, in and of itself, show inadequate planning, performance, or judgment on the part of the auditor.

Illegal Acts--Indirect and Material

6.16 With respect to detecting and reporting illegal acts that do not directly relate to specific financial statement amounts, the auditor should be aware of the possibility that certain types of illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed at ascertaining whether an illegal act has occurred.

6.17 Examples of such illegal acts may include violations of occupational safety and health, environmental, food and drug, and price-fixing laws and regulations. In general, these laws and regulations relate more to the

nonfinancial operations of a government, and accordingly, they have only an indirect effect on the financial statements. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Due to the indirect nature of such violations, an audit made in accordance with GAAS provides no assurance that these violations will be detected or that any contingent liabilities that may result will be disclosed.

Reporting

6.18 When performing an audit in accordance with GAAS, the auditor should consider the impact of any instance of noncompliance on the financial statement opinion. When auditing in accordance with Government Auditing Standards, a report on the results of the auditor's testing of compliance with laws and regulations at the GPFS level is required to be issued. An example of this compliance report is presented in paragraph 22 of SAS 63 and in example 17 of SOP 89-6.

6.19 Government Auditing Standards requires the auditor to report instances or indications of illegal acts that could result in criminal prosecution. However, the auditor ordinarily does not possess the expertise to form a conclusion about whether an illegal act or possible illegal act could result in criminal prosecution. Thus, in complying with this requirement, the auditor may choose to report all illegal acts or possible illegal acts noted. Government Auditing Standards provides the following guidance on reporting illegal acts:

Public accountants conducting audits of governmental entities will discharge their responsibilities for reporting illegal acts or indications of such acts found during or in connection with an audit by promptly reporting to the top official of the entity arranging for the audit (including audit committees or others with equivalent authority). The auditor should also consider reporting to the appropriate oversight body. If the audited entity and the top official are believed to be parties to such acts or otherwise implicated, the auditor should in all cases report to the appropriate oversight body. Also, when the illegal acts involve funds received from other government entities, the audited entity should report to the proper officials, including those at the audit organization, of those entities. If the audited entity does not do so within a reasonable time or was unable to because the top official was involved, the auditor should report to the officials of those other government entities.

Illegal acts or indications of such acts that the auditor becomes aware of need not be included in the required audit reports, but may be covered in a separate written report and submitted in accordance with the preceding paragraphs, thus permitting the required report or reports to be released. However, auditors generally should not release information or reports containing information on such acts or reports with references that such acts were omitted from reports, without consulting with appropriate legal counsel, since this release could interfere with legal processes, subject the implicated individuals to undue publicity, or subject the auditor to potential legal action.

6.20 Government Auditing Standards also requires that the auditor's internal control report include the entity's significant internal controls or control structure, including those controls (for example, administrative controls) established to ensure compliance with laws and regulations that have a material impact on the financial statements. Significant controls, including compliance controls, should be identified in the auditor's report on internal control. This reporting requirement is among the issues addressed in appendix C of this statement, which discusses how federal inspectors general assess the quality of single audits.

APPENDIX A

KEY EVENTS IN THE HISTORY OF AUDITING FEDERAL PROGRAMS

A.1 From the 1960s to the present, federal assistance to state and local governments grew from a few billion dollars to an annualized level of over \$100 billion, and the debt securities sold by some 40,000 governmental entities to the public are valued at market rates in the hundreds of billions of dollars.

A.2 Since the 1960s, there has been an evolution in the nature of audits made of federally assisted programs and the type of auditors performing such audits. The principal events in the decades since the 1960s have been highlighted by the issuance of more guidance relating to audits of federal programs, and this guidance has been increasingly specific and increasingly detailed.

A.3 Throughout the 1960s, the federal government supported a concept of grant-by-grant audits. By the mid-1970s, more than 100 individual program audit guides had been issued. As a partial response to the myriad of program audit guides, the U.S. General Accounting Office attempted to bring uniformity to audits of government programs, activities, and functions through the issuance of Government Auditing Standards. These standards were initially issued by the GAO in 1972 and were revised in 1974, 1981, and most recently in 1988.

A.4 In 1972 the U.S. Office of Management and Budget (OMB) issued government-wide administrative regulations governing the administration of grants and contracts with state and local governments. This guidance was contained in OMB Circular A-102, Uniform Requirements for Assistance to State and Local Governments.

A.5 In 1979 the OMB issued Attachment P, "Audit Requirements," to OMB Circular A-102, requiring that a single audit be made of federal assistance programs managed or administered by individual government units and that the single audit report be accepted by all federal agencies. The Single Audit Act (P.L. 98-502, 31 U.S.C. 7501-7807), passed by Congress in 1984, codified many of the audit requirements established administratively under Attachment P.

A.6 Subsequent to the passage of the Single Audit Act, significant guidance relating to audits of federal programs has included the following:

- o In April 1985 the OMB issued Circular A-128, Audits of State and Local Governments, to implement the Single Audit Act. OMB Circular A-128 superseded Attachment P to OMB Circular A-102.
- o In 1980 the OMB, in cooperation with many federal agencies, issued the Compliance Supplement for Single Audits of State and Local Governments (most recently revised in 1990). The Compliance Supplement contains the legal and regulatory requirements, along with suggested audit procedures, for the most significant federal assistance programs,

which comprise about 95 percent of the total federal financial assistance provided to state and local governments.

- o In 1986 the AICPA revised the Audit and Accounting Guide Audits of State and Local Governmental Units to address the specialized reporting principles and auditing practices related to the audit of federal financial assistance programs under the Single Audit Act.
- o In 1987 the AICPA published the Report of the Task Force on the Quality of Audits of Governmental Units. The primary objective of the task force was to develop a comprehensive plan of action designed to improve the quality of audits of governmental units. The task force identified twenty-five specific recommendations for improving the quality of audits. These recommendations have been categorized into five areas commonly referred to as the "five Es": education, engagement, evaluation, enforcement, and exchange. In 1989 the task force issued a final report on the successful implementation of all but one of the twenty-five recommendations.
- o In March 1988 the OMB issued a revised Circular A-102, Uniform Administrative Requirements for Grants and Other Agreements with State and Local Governments.
- o In April 1989 the AICPA issued Statement on Auditing Standards No. 63, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance. This Statement describes the auditor's responsibility for testing and reporting on compliance with laws, regulations, and contractual terms governing financial assistance received from the federal government.
- o In 1990, the OMB issued Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions. This circular supersedes paragraph 2h of Attachment F to OMB Circular A-110 and represents the audit requirements for colleges and universities and nonprofit organizations receiving federal financial assistance. However, certain colleges and universities may continue to have audits conducted in accordance with OMB Circular A-128.

A.7 Today there are more than 15,000 governments required to have audits under the Single Audit Act. The majority of these audits are done by independent certified public accountants.

APPENDIX B

SINGLE AUDIT LITERATURE IN EFFECT AS OF JANUARY 1, 1991

B.1 Single audits are conducted in accordance with GAAS, Government Auditing Standards, and the Single Audit Act. Individuals performing single audit engagements need to be aware of guidance on the interpretation of these three items and other authoritative information.

B.2 The auditor should be familiar with the requirements for audits of federal financial assistance programs. In planning, conducting, and reporting in connection with a single audit, independent auditors should become familiar with the following pertinent documents, many of which were discussed previously in this SOP:

- o The AICPA audit and Accounting Guide Audits of State and Local Governmental Units (1986)
- o The Single Audit Act of 1984, enacted in October 1984 (appendix E of the AICPA audit and accounting guide)
- o OMB Circular A-128, Audits of State and Local Governments, issued in April 1985 (appendix F of the AICPA audit and accounting guide)
- o OMB Circular A-87, Cost Principles Applicable to Grants and Contracts, issued January 1981 (appendix D of the AICPA audit and accounting guide contains a synopsis)
- o OMB Circular A-102, Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments, issued in March 1988 and effective October 6, 1988 (appendix D of the AICPA audit and accounting guide contains a synopsis)
- o Uniform Administrative Requirements for Grants and Cooperative Agreements with State and Local Governments--Final Rule (Common Rule), effective October 6, 1988 (Federal Register, Vol. 53, No. 48, March 11, 1988)
- o Government Auditing Standards (1988 revision), issued by the Comptroller General of the United States (frequently referred to as the "Yellow Book")
- o Assessing Compliance with Applicable Laws and Regulations, issued in December 1989 by the U.S. General Accounting Office, Office of Policy
- o OMB Compliance Supplement for Single Audits of State and Local Governments, revised in September 1990
- o Federal Cognizant Agency Audit Organization Guidelines, revised in November 1987 by the President's Council on Integrity and Efficiency (PCIE) (frequently referred to as the "Orange Book")

- o PCIE Position Statements--statements dealing with implementation issues of the single audit and serving essentially as supplemental guidance to federal officials beyond the "Orange Book":
 - Statement 1--involves guidance when a series of audits of individual departments, agencies, and establishments may be considered an audit for single audit purposes (issued February 4, 1987)
 - Statement 2--endorses "50-percent rule" on internal control coverage prescribed by the AICPA audit and accounting guide (issued February 4, 1987)
 - Statement 3--involves guidance on frequency of required internal control reviews of nonmajor programs (issued July 19, 1988)
 - Statement 4--establishes uniform procedures for referral of substandard audits to state boards of accountancy and the AICPA (issued December 5, 1988)
 - Statement 5--establishes audit guidance for "other nonprofit" entities not covered by OMB Circular A-110 (issued September 8, 1989)
- o OMB Catalog of Federal Domestic Assistance--compiled and published annually by the General Services Administration and available from the Superintendent of Documents, U.S. Government Printing Office
- o OMB Questions and Answers--publication that addresses a number of the implementation issues of Circular A-128 (Federal Register, Vol. 52, No. 219, pp. 43712-43718, November 13, 1987)
- o PCIE's Uniform Desk Review and Quality Control Review Guides for Single Audits--used by the personnel of the Federal Inspector General (IG) to review the quality of audit reports and an auditor's workpapers when a single audit is reviewed by IG personnel. These guides are available upon request to the Office of Inspector General for Audit
- o AICPA Statement of Position (SOP) Nos. 89-6, Auditors' Reports in Audits of State and Local Governmental Units (amends the AICPA audit and accounting guide); 90-4, Auditors' Reports Under U.S. Department of Housing and Urban Development's Audit Guide for Mortgages Having HUD Insured or Secretary Held Multifamily Mortgages; and 90-9, The Auditor's Consideration of the Internal Control Structure Used in Administering Federal Financial Assistance Programs Under the Single Audit Act (amends SOP 89-6, example 26)

APPENDIX C

FEDERAL QUALITY CONTROL PROCEDURES

C.1 Not all single audit reports received by the cognizant agency are subjected to all the quality control procedures included in the Orange Book. Reports that are examined are usually selected on a statistical or random basis established by each cognizant agency. The sequential phases through which audit reports may be subjected for review include a desk review, a workpaper review, an on-site review, and a quality assessment review of the audit organization.

DESK REVIEWS

C.2 Substantially all single audit reports receive a desk review by the cognizant agency. The principal purpose of a desk review is to determine whether all the individual reports and the corrective plan of action required by the Single Audit Act and Circular A-128 have been received. The cognizant agencies, through the PCIE, have developed a uniform desk review checklist that sets forth the following principal subjects to be addressed:

- o Qualifications of the auditor--Do the single audit reports contain any indication that the auditor does not meet the qualifications and independence standards contained in Government Auditing Standards?
- o Financial statements--Do the single audit reports contain all required financial statements, including notes thereto, and the Supplementary Schedule of Federal Financial Assistance, and do they indicate whether the financial statements and the Schedule cover the entire operations of the government? Do they also indicate whether the auditor's report on the financial statements states that the audit has been done in accordance with Government Auditing Standards and whether the report contains an opinion on whether the financial statements are presented fairly in accordance with GAAP? Further, do the single audit reports indicate whether the auditor's report is included on the Schedule?
- o Internal control structure--Do the single audit reports include the auditor's reports on the government's internal control structure observed during the audit of the financial statements and on the government's management of federal financial assistance programs, and do these reports include the identification of the significant controls designed to provide reasonable assurance that federal programs are being managed in compliance with applicable laws and regulations?
- o Compliance--Do single audit reports include the necessary auditor's reports, as applicable? If there are major federal financial assistance programs, an opinion on the specific compliance requirements, a report giving positive and negative assurance on the general compliance requirements, and a report giving positive and negative assurance on the specific compliance items tested for

nonmajor federal financial assistance programs are all required. If there are no major federal financial assistance programs, reports giving positive and negative assurance on the general compliance requirements for the specific compliance items tested for nonmajor federal financial assistance programs are required.

- o Other matters--Does the information on the identification of amounts, questions, noncompliance, and the findings and recommendations provided by the auditor present sufficient detail to facilitate resolution by federal program officials, and does the government provide comments and a corrective action plan addressing all the auditor's findings and recommendations?

WORKPAPER REVIEWS

C.3 Although the desk review may be an effective method for the cognizant agency to determine whether the single audit report meets the reporting requirements of the Single Audit Act and OMB Circular A-128, it does not provide an assessment of the quality of the work performed by the auditor. Each cognizant agency has established procedures for selecting a representative number of single audits on which to perform a review of the auditor's workpapers.

C.4 The workpaper review will cover all aspects of the audit work, with particular emphasis on the audit of federal funds. As with desk reviews, the cognizant agencies, through the PCIE, have developed a uniform checklist that sets forth the following principal subjects to be addressed:

- o Audit engagement--Was an audit engagement letter or other agreement executed?
- o Auditor independence--Are the workpapers free of any indication that the auditor lacks independence due to personal or external impairment?
- o Auditor qualifications--Is the auditor a licensed CPA or a PA licensed on or before December 31, 1970? Furthermore, has the auditor met Government Auditing Standards requirements for continuing professional education (CPE) and peer/quality reviews?
- o Planning and supervision--Is there evidence that the auditor possessed or performed procedures to acquire sufficient knowledge to understand the government's internal control structure as it affects the financial statements and the management of federal financial assistance programs?
- o Fieldwork--Do the audit procedures employed and the tests performed in obtaining evidential matter comply with Government Auditing Standards?
- o CPE--Have the auditors complied with the appropriate CPE requirements?
- o Quality reviews--Does the audit organization have an internal quality control review process established and does it participate in an external quality review program?

- o Books and records--Are there sufficient data to demonstrate that the financial statements, the Supplementary Schedule of Federal Financial Assistance, and other data on which the auditor is reporting are either in agreement, or have been reconciled, with the government's records?
- o Findings and recommendations--Do the reports issued by the auditor include all major internal control weaknesses and all instances of noncompliance identified in the workpapers? Furthermore, has the auditor ensured that all potential illegal acts were reported to the appropriate officials?

ON-SITE REVIEWS

C.5 In selected instances, the cognizant agency may elect to perform an on-site review to compare the auditor's workpapers with the government's books and records to ensure that the workpapers accurately portray the conditions cited.

REVIEWS OF AUDIT ORGANIZATION

C.6 In determining the depth of coverage to be examined during an on-site review, the cognizant agency may review and consider the results of any quality reviews performed under any of the programs recognized as acceptable in Government Auditing Standards.

RESOLVING DEFICIENCIES NOTED

C.7 When the cognizant agency identifies any deficiencies noted during its desk, workpaper, or on-site reviews, it will notify the auditor and government in writing, setting forth the--

- o Reason why the work is inadequate.
- o Impact of the noted inadequacies.
- o Recommendations for resolving the inadequacies.
- o Time frame for accomplishing corrective action.
- o Possible sanctions if corrective action is not taken.

C.8 If corrective action does not occur, the cognizant agency may initiate a series of sanctions, including--

- o Recommending that the audited government impose any sanctions provided for in their contract for audit services.
- o Recommending that the federal agencies impose any of the sanctions set forth in Circular A-128, which include withholding a part or all of

any federal assistance payments due the government, withholding or disallowing overhead payments, or suspending the federal grant agreement until an acceptable single audit is completed.

- o Invoking the provision in the Single Audit Act that no audit cost may be charged to federal assistance programs for audits not made in accordance with OMB Circular A-128 requirements.
- o Referring substandard work to appropriate professional and regulatory bodies, if warranted. In PCIE Position Statement No. 4, the cognizant agencies have developed a uniform package that they use for referring substandard work.

APPENDIX D

ILLUSTRATIVE AUDITOR'S REPORTS

EXAMPLE 1. INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AT THE GENERAL-PURPOSE FINANCIAL STATEMENT LEVEL WHEN UNCERTAINTY ABOUT COMPLIANCE EXISTS¹

Independent Auditor's Report

We have audited the general-purpose financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated September 8, 19X1.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [name of entity] is the responsibility of the management of [name of entity]. As part of obtaining reasonable assurance about whether the general-purpose financial statements are free of material misstatement, we performed tests of [name of entity]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the general-purpose financial statements. The results of our tests of compliance disclosed the following instances of noncompliance that may be material to the general-purpose financial statements but for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in [name of entity]'s 19X1 financial statements.²

[Include paragraphs describing the instances of noncompliance noted.]

We considered these instances of noncompliance in forming our opinion on whether [name of entity]'s 19X1 general-purpose 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 September 8, 19X1, on those general-purpose financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [name of entity] 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 entity] 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]

September 8, 19X1

Notes:

1. See note at paragraph 5.32.
2. 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 general-purpose financial statements and, if necessary, an explanatory paragraph similar to the following should be inserted in the auditor's report on the general-purpose financial statements after the opinion paragraph:

As discussed in note X, [name of entity] failed to comply with certain federal financial assistance requirements for programs that may be material to the special revenue fund type. The general-purpose 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 may be material enough either individually or in the aggregate to warrant a disclaimer of opinion on the general-purpose financial statements.

EXAMPLE 2. INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH THE GENERAL REQUIREMENTS APPLICABLE TO FEDERAL FINANCIAL ASSISTANCE PROGRAMS¹

Independent Auditor's Report on Compliance With General Requirements

We have audited the general-purpose financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated September 8, 19X1.

We have also applied procedures to test [name of entity]'s compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the schedule of federal financial assistance,² for the year ended June 30, 19X1: [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 entity]'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 entity] 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.³

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]

September 8, 19X1

Notes:

1. This report would be issued to satisfy the Single Audit Act requirement to report on federal program general compliance requirements when no material instances of noncompliance were noted. It supersedes example 23 of SOP 89-6.
2. Major programs need to be clearly identified in the schedule of federal financial assistance.
3. If there are no immaterial instances of noncompliance noted, this sentence should be deleted.

EXAMPLE 3. INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH GENERAL REQUIREMENTS--MATERIAL NONCOMPLIANCE IDENTIFIED

Independent Auditor's Report on Compliance With General Requirements

We have audited the general-purpose financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated September 8, 19X1.

We have also applied procedures to test [name of entity]'s compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the schedule of federal financial assistance,¹ for the year ended June 30, 19X1: [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 entity]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow the general requirements that caused us to conclude that the misstatements resulting from those failures are material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance that are described in the accompanying schedule of findings and questioned costs.²

We considered these material instances of noncompliance in forming our opinion on whether [name of entity]'s 19X1 general-purpose 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 September 8, 19X1, on those financial statements.

Except as described above, the results of our procedures to determine compliance indicate that, with respect to the items tested, [name of entity] complied, in all material respects, with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those requirements. However, the results of our procedures also disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.³

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]

September 8, 19X1

Notes:

1. Major programs need to be clearly identified in the schedule of federal financial assistance.
2. If, individually or collectively, the instances of noncompliance are also material to the general-purpose financial statements, the report is modified as follows:

[First three paragraphs are the same as in the report illustrated in example 17 of SOP 89-6.]

Material instances of noncompliance are failures to follow requirements or violations of prohibitions, contained in laws, regulations, contracts, or grants, that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the general-purpose financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in the 19XX general-purpose financial statements of [name of entity].

[Include paragraphs describing the material instances of noncompliance noted.]

We considered these material instances of noncompliance in forming our opinion on whether the 19XX general-purpose 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 general-purpose financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [name of entity] 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 entity] 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]

September 8, 19X1

3. If there are no immaterial instances of noncompliance noted, this sentence should be deleted.

EXAMPLE 4. INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH GENERAL REQUIREMENTS APPLICABLE TO FEDERAL FINANCIAL ASSISTANCE PROGRAMS INVOLVING A SCOPE LIMITATION

Independent Auditor's Report on Compliance With General Requirements

We have audited the general-purpose financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated September 8, 19X1.

We have also applied procedures to test [name of entity]'s compliance with the following requirements applicable to its federal financial assistance programs, which are identified in the schedule of federal financial assistance, for the year ended June 30, 19X1: [List the general requirements tested].

Except as described in the following paragraph, our procedures were limited to the applicable procedures described in the Office of Management and Budget's Compliance Supplement for 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 entity]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

We were unable to obtain sufficient documentation of [name of entity]'s compliance with the cash management and relocation assistance and real property acquisition requirements of Major Program ABC, nor were we able to satisfy ourselves by alternative procedures as to [name of entity]'s compliance with those requirements of Major Program ABC.

With respect to the items tested, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding [name of entity]'s compliance with the cash management and relocation assistance and real property acquisition requirements of Major Program ABC, [name of entity] complied, in all material respects, with the requirements listed in the first paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] had not complied, in all material respects, with those requirements. The results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.

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

[Signature]

September 8, 19X1

EXAMPLE 5. INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO MAJOR FEDERAL FINANCIAL ASSISTANCE PROGRAMS INVOLVING UNCERTAINTIES¹

Independent Auditor's Report on Compliance With
Specific Major Program Requirements

We have audited the general-purpose financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated September 8, 19X1.

We have also audited [name of entity]'s compliance with the requirements governing [list requirements tested] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance,² for the year ended June 30, 19X1. The management of [name of entity] is responsible for [name of entity]'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-128, Audits of State and Local Governments. Those standards and OMB Circular A-128 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 entity]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures for the U.S. Department of Education's Impact Aid--Maintenance and Operations program disclosed that [name of entity] did not comply with the requirements that the number of children in the program equal at least 400 or 3 percent of the total number of children in average daily attendance. In our opinion, [name of entity]'s compliance with this requirement is necessary for [name of entity] to comply with the requirements applicable to the program.

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.³ We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for those instances of noncompliance with requirements applicable to the U.S. Department of Education's Impact Aid--Maintenance and Operations program referred to in the fourth paragraph of this report and identified in the accompanying schedule of findings and questioned costs, [name of entity] complied, in all material respects, with the requirements governing [list requirements tested] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

Resolving instances of noncompliance identified in the third and fourth paragraphs of this report is the responsibility of the U.S. Department of Education. 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 financial assistance and no provision for any liability that may result has been recognized in [name of entity]'s 19X1 financial statements.

We considered these instances of noncompliance in forming our opinion on whether [name of entity]'s 19X1 general-purpose 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 September 8, 19X1, on those financial statements.

[Signature]

September 8, 19X1

Notes:

1. This report would be issued to satisfy the Single Audit Act 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 financial assistance.
3. If there are no instances of noncompliance relating to major programs noted, this paragraph should be deleted.

EXAMPLE 6. UNQUALIFIED OPINION ON GENERAL-PURPOSE OR COMPONENT-UNIT FINANCIAL STATEMENTS--AUDITED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Independent Auditor's Report

We have audited the accompanying general-purpose financial statements of [name of entity] as of June 30, 19X1, and for the year then ended.¹ These general-purpose financial statements are the responsibility of [name of entity]'s management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of [name of entity] as of June 30, 19X1, and the results of operations and cash flows of its proprietary and similar trust fund types for the year then ended in conformity with generally accepted accounting principles.

[Signature]

September 8, 19X1

Notes:

1. If the financial statements are for a component unit, the term general-purpose financial statements should not be used. In the case of a component unit other than the oversight unit, the term component unit financial statements or just financial statements should be used. For the component unit financial statements of an oversight unit, see SOP 89-6, example 4.

EXAMPLE 7. INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO MAJOR AND NONMAJOR FEDERAL FINANCIAL ASSISTANCE PROGRAMS¹

Independent Auditor's Report on Compliance With Specific
Major and Nonmajor Program Requirements

We have audited the general-purpose financial statements of [name of entity] as of and for the year ended June 30, 19X1, and have issued our report thereon dated September 8, 19X1.

We have also audited [name of entity]'s compliance with the requirements governing [list requirements tested] that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 19X1. The management of [name of entity] is responsible for [name of entity]'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-128, Audits of State and Local Governments. Those standards and OMB Circular A-128 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 entity]'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 entity] complied, in all material respects, with the requirements governing [list requirements tested] that are applicable to each of its major federal financial assistance programs for the year ended June 30, 19X1.

In connection with our audit of the 19X1 general-purpose financial statements of [name of entity] and with our study and evaluation of [name of entity]'s internal control structure used to administer federal financial assistance programs, as required by OMB Circular A-128, we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 19X1.

As required by OMB Circular A-128, we have performed auditing 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 entity]'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 preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [name of entity] 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]

September 8, 19X1

Notes:

1. This report would be issued to satisfy the Single Audit Act requirement to report on specific compliance requirements for major and nonmajor programs when no material instances of noncompliance were noted. It would be issued rather than issuing the two separate reports contained in SOP 89-6 (examples 18 and 24).