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Government auditing standards and circular A-133 audits, with conforming changes as of August 1, 2008; Audit and accounting guide

American Institute of Certified Public Accountants. Single Audit Working Group

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Government Auditing Standards and Circular A-133 Audits – August 1, 2008

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS



A U D I T G U I D E

Government Auditing Standards and Circular A-133 Audits

AUGUST 1, 2008



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A U D I T G U I D E

Government Auditing Standards and Circular A-133 Audits

WITH CONFORMING CHANGES AS OF
AUGUST 1, 2008

Includes guidance on the July 2007 revision to *Government Auditing Standards* and the Single Audit Act Amendments of 1996 and the June 26, 2007, revision to Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*

This AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits*, was originally issued as Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, in March 1998. This edition has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the guidance was originally issued. The changes made are identified in a schedule in appendix D of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Notice to Readers

This Audit Guide (guide) presents guidance for the audits of financial statements conducted in accordance with *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. Government Accountability Office (GAO). It also presents the recommendations of the AICPA Single Audit Working Group for the conduct of audits in accordance with the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. This guide incorporates guidance contained in AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1). Auditors of the financial statements of entities subject to the guidance in this guide also should refer to other applicable AICPA Audit and Accounting Guides, including *Health Care Organizations, Not-for-Profit Organizations, and State and Local Governments*.

Auditing guidance included in an AICPA Audit Guide is an interpretive publication pursuant to AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Interpretive publications are recommendations on the application of Statements on Auditing Standards (SASs) in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The members of the ASB have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If an auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

Defining Professional Requirements

AU section 120, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1), and AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1), which were issued in December 2005, set forth the meaning of certain terms used in SASs and Standards for Attestation Engagements (SSAEs), respectively, issued by the ASB in describing the professional requirements imposed on auditors and practitioners. The specific terms used to define professional requirements in these sections are not intended to apply to interpretive publications issued under the authority of the ASB because interpretive publications are not auditing or attestation standards. It is the ASB's intention to make conforming changes to the interpretive publications over the next several years to remove any language that would imply a professional requirement where none exists.

In December 2007, the Accounting and Review Services Committee (ARSC) issued AR section 20, *Defining Professional Requirements in Statements on Stan-*

dards for Accounting and Review Services (AICPA, *Professional Standards*, vol. 2), which sets forth the meaning of certain terms used in Statements on Standards for Accounting and Review Services (SSARS) issued by the ARSC in describing the professional requirements imposed on accountants performing a compilation or review of a nonissuer. The specific terms used to define professional requirements in this section are not intended to apply to interpretive publications issued under the authority of the ARSC because interpretive publications are not SSARSs. It is the ARSC's intention to make conforming changes to the interpretive publications to remove any language that would imply a professional requirement where none exists.

AU section 120, AT section 20, and AR section 20, which were effective upon issuance, define the terminology that the ASB and ARSC will use going forward to describe the degree of responsibility that the requirements impose on the auditor, practitioner, or accountant in engagements performed for nonissuers. SASs, SSAEs, and SSARSs will use the words *must* or *is required* to indicate an unconditional requirement, with which the auditor, practitioner, or accountant is required to comply. SASs, SSAEs, and SSARSs will use the word *should* to indicate a presumptively mandatory requirement. The auditor, practitioner, or accountant is required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the auditor, practitioner, or accountant may depart from a presumptively mandatory requirement provided he or she documents the justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. If a SAS, SSAE, or SSARS provides that a procedure or action is one that the auditor, practitioner, and accountant *should consider*, the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not.

This guide has been updated as applicable for AU section 120, AT section 20, and AR section 20. Refer to appendix D, "Schedule of Changes Made to *Government Auditing Standards* and Circular A-133 Audits," for additional information.

Government Auditing Standards—Defining Professional Requirements

Chapter 1 of *Government Auditing Standards*, July 2007 Revision contains a discussion of the use of terminology to define professional requirements, which is very similar to the material in AU section 120. In December 2007, GAO issued *Government Auditing Standards: Implementation Tool—Professional Requirements Tool for Use in Implementing Requirements Identified by "Must" and "Should" in the July 2007 Revision of Government Auditing Standards* (GAO-08-210G, December 2007). This professional requirements tool lists the requirements for audit organizations and auditors included in *Government Auditing Standards*, July 2007 Revision. Sections of this guide that discuss *Government Auditing Standards* have been updated to be consistent with the professional requirements terminology used in *Government Auditing Standards*, July 2007 Revision.

Recognition

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Guidance Considered in this Edition

This guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. Relevant guidance contained in official pronouncements issued through August 1, 2008, has been considered in the development of this edition of the guide. This includes relevant guidance issued up to and including the following:

- SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380)
- Auditing Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" of AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9325A par. .01–.04)
- The Single Audit Act Amendments of 1996 (hereinafter referred to as the Single Audit Act)
- OMB Circular A-133 (as revised by *Federal Register* Notice on June 26, 2007)
- *Government Auditing Standards*, July 2007 Revision

Users of this guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this guide. In determining the applicability of a pronouncement, its effective date should be considered. The changes made to this edition of the guide are identified in the Schedule of Changes at appendix D. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Risk Assessment Standards in This Guide

In March 2006, the ASB issued SAS Nos. 104–111 (the "risk assessment standards"). Collectively, the risk assessment standards establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement (whether caused by fraud or error) in a nonissuer financial statement audit; design and performance of tailored audit procedures to address assessed risks; audit risk and materiality; planning and supervision; and audit evidence. The most significant changes to existing practice that the auditor will be required to perform are as follows:

- Obtain a more in-depth understanding of the audited entity and its environment, including its internal control.
- Perform a more rigorous assessment of the risks of where and how the financial statements could be materially misstated (defaulting to a maximum control risk is not acceptable).
- Provide a linkage between the auditor's assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The statements are effective for audits of financial statements for periods beginning on or after December 15, 2006. See appendix C, "Comparison of Key Provisions of the Risk Assessment Standards to Previous Standards," for a more detailed comparison between the risk assessment standards and the superseded standards. The Yellow Book incorporates all of the fieldwork and reporting standards of the AICPA by reference and therefore the risk assessment standards should be followed for audits of financial statements performed under *Government Auditing Standards*. For more information on the risk assessment standards in a financial statement audit please refer to the Audit and Accounting Guides *Not-for-Profit Organizations* and *State and Local Governments* because they have been updated for these standards. For additional guidance on the risk assessment standards, please refer to the AICPA Audit Guide *Assessing and Responding to Risk in a Financial Statement Audit* (product no. 012456), and the AICPA Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526).

With regard to the audit of compliance performed under Circular A-133, the process of conforming changes related to the risk assessment standards has begun with this edition of the guide. For example, terminology and references to AU sections have been modified to be consistent with the risk assessment standards. The AICPA ASB is in the process of revising AU section 801, which may result in further clarifications regarding the implementation of the risk assessment standards to compliance audits performed under generally accepted auditing standards. (The proposed revisions to AU section 801 are expected to be exposed for public comment in the fall of 2008, with a final updated standard

to be issued sometime in 2009.) As a result, any additional needed changes to this guide will be made in future editions.

Defining Professional Requirements

As previously stated, this guide has been conformed to the standards found in AU section 120, AT section 20, and AR section 20, which were effective upon issuance (December 2005, except for AR section 20, which was issued in December 2007). These new standards define the terminology that the ASB and ARSC will use going forward to describe the degree of responsibility that the requirements impose on the auditor, practitioner, or accountant in engagements performed for nonissuers. Refer to the Schedule of Changes at appendix D for additional information.

Preface

Purpose and Applicability

This Audit Guide (guide) provides guidance (chapters 1–4) on the auditor's responsibilities when conducting an audit of financial statements in accordance with *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. Government Accountability Office (GAO). This guide has been prepared using the *Government Audit Standards*, July 2007 Revision.

It also provides guidance (chapters 1 and 5–13) on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. This guide was originally issued as Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (AICPA, *Technical Practice Aids*), in March 1998, and updated annually for conforming changes for relevant guidance contained in authoritative auditing standards and other requirements. The AICPA converted SOP 98-3 into an Audit Guide in 2003. That conversion did not supersede the guidance that appeared in SOP 98-3 but only changed its format.

Concerning an audit of financial statements in accordance with *Government Auditing Standards*, this guide:

- Describes the applicability of *Government Auditing Standards*
- Discusses the relationship between generally accepted auditing standards and *Government Auditing Standards*
- Discusses the general standards and additional fieldwork and reporting standards of *Government Auditing Standards*
- Describes the auditor's responsibility for considering internal control over financial reporting, compliance with applicable laws, regulations, and provisions of contracts and grants agreements, fraud, and abuse
- Describes the auditor's responsibility for reporting and other communications and provides examples of the required auditor's reports

Concerning an audit of federal awards in accordance with Circular A-133, this guide:

- Describes the applicability of and provides an overview of the requirements of the Single Audit Act and Circular A-133
- Discusses the relationship between *Government Auditing Standards* and Circular A-133
- Describes the auditor's additional responsibilities for considering internal control over compliance with applicable laws, regulations, and program compliance requirements; performing tests of compliance with those requirements; and performing procedures on the schedule of expenditures of federal awards
- Describes the auditor's responsibilities in a program-specific audit

- Describes the auditor's responsibility for reporting and provides examples of the required auditor's reports

Further, this guide incorporates guidance from the following documents:

- AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1)
- *Government Auditing Standards*, July 2007 Revision
- The Single Audit Act and Circular A-133 (as revised by *Federal Register* Notice on June 26, 2007) and the OMB Circular A-133 *Compliance Supplement*

References to Professional Standards

In citing the professional standards, references are made to the AICPA *Professional Standards* publication. When referencing professional standards, this guide cites section numbers and not the original statement number, as appropriate. For example, SAS No. 54 is referred to as AU section 317.

Effect of PCAOB Standards on Entities Subject to Government Auditing Standards

The Public Company Accounting Oversight Board (PCAOB) establishes standards for audits of *issuers*, as that term is defined by the Sarbanes-Oxley Act of 2002 or whose audit is prescribed by the rules of the Securities and Exchange Commission (SEC). Other entities are referred to as *nonissuers*. Although many entities that are subject to *Government Auditing Standards* are nonissuers, some are issuers. Such issuers may include, for example, lending institutions that participate in federally sponsored loan programs such as housing and education. In December 2007, the GAO issued guidance titled "Guidance on Complying with *Government Auditing Standards* Reporting Requirements for the Report on Internal Control for Audits of Certain Entities Subject to the Requirements of the Sarbanes-Oxley Act of 2002 and *Government Auditing Standards*" that recognizes that the use of PCAOB's framework for assessing control deficiencies could result in inconsistencies in reporting internal control deficiencies under the Yellow Book. The GAO guidance facilitates the reporting of internal control deficiencies identified during audits conducted under both PCAOB and Yellow Book standards to ensure the consistency of information included in the Yellow Book report on internal control and to assist auditors in complying with Yellow Book standards. It is available on the Yellow Book Web site at www.gao.gov/govaud.ybk01.htm.

Effective Date

The provisions of this guide are applicable to audits of fiscal years beginning after June 30, 1996, in which the related fieldwork commences on or after March 1, 1998. The provisions of this guide, including conforming changes, that arise from AICPA auditing standards, *Government Auditing Standards*, the Single Audit Act, and Circular A-133 are effective as of the effective date of those standards and requirements. This guide does not change the effective

dates of those standards and requirements. The auditing conforming changes made in this edition of this guide are effective for audits of financial statements for which sufficient appropriate audit evidence to support the opinion is obtained after its issuance, subject to the effective dates of the underlying authoritative pronouncements.

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Chapter 1

Introduction

Note: *Government Auditing Standards* is periodically amended and codified. This guide includes guidance from the most recent revision of *Government Auditing Standards* issued July 2007, which was effective for financial audits, including financial statement audits, for periods beginning on or after January 1, 2008. Auditors who are performing audits conducted under the previous version of *Government Auditing Standards*, issued in 2003, can refer to the prior edition of this guide dated May 1, 2007, for the applicable guidance.

Purpose and Applicability

1.01 This Audit Guide (guide) has a two-fold purpose.

- a. The first purpose is to provide auditors with a basic understanding of the procedures they should perform and of the reports they should issue for audits of financial statements conducted in accordance with *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. Government Accountability Office (GAO).¹ *Government Auditing Standards* incorporates the fieldwork and reporting standards of generally accepted auditing standards (GAAS) and the related Statements on Auditing Standards (SASs) issued by the AICPA unless the Comptroller General of the United States excludes them by formal announcement.²
- b. The second purpose is to provide auditors of states, local governments, and not-for-profit organizations (NPOs) that receive federal awards with a basic understanding of the procedures they should perform and of the reports they should issue for single audits and program-specific audits conducted in accordance with the Single Audit Act Amendments of 1996 (the Single Audit Act),³ Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*,⁴ and the related OMB Circular A-133 *Compliance Supplement*,⁵ which incorporate the procedures and reports required by *Government Auditing Standards*.

1.02 *Government Auditing Standards* contain requirements and guidance for financial audits, attestation engagements, and performance audits. This guide addresses the *Government Auditing Standards* requirements and guidance for financial audits, and generally only as they relate to audits of financial statements prepared in conformity with generally accepted accounting principles (GAAP or an other comprehensive basis of accounting) and audits conducted in accordance with the Single Audit Act and OMB Circular A-133. Therefore, any reference in *Government Auditing Standards* to attestation engagements or performance audits are not included in this guide.

¹ The standards and guidance applicable to financial audits, including audits of financial statements, are contained in chapters 1-5 of *Government Auditing Standards* and include ethical principles and general, fieldwork, and reporting standards. An electronic version of *Government Auditing Standards* is on the Yellow Book page of the Government Accountability Office (GAO)'s Web site at www.gao.gov/govaud/ybk01.htm. The Yellow Book page of the GAO Web site also provides instructions for obtaining a printed copy of the standards.

² To date, the Comptroller General has not excluded any fieldwork or reporting standards or related statements on auditing standards (SAS).

³ The Single Audit Act (Public Law 104-156) was enacted into law in July 1996 and replaced the Single Audit Act of 1984. Appendix A of this guide is a reprint of the Single Audit Act.

⁴ Appendix B of this guide reprints Circular A-133, as revised on June 27, 2003. The Office of Management and Budget (OMB) again revised Circular A-133 on June 26, 2007, to, among other things, adopt terminology from AU section 325A (SAS No. 112), *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1). As of the date of the printing of this guide, a complete version of the 2007 revised circular was not available. However, the 2003 version of the circular and the June 26, 2007 Federal Register notice that further revised the circular can be obtained from the OMB's Web site at www.omb.gov/grants/grants_circulars.html.

⁵ The Office of Management and Budget (OMB) Circular A-133 *Compliance Supplement* is updated annually. It is available from the Government Printing Office by calling (202) 512-1800 and on the OMB's Web site at www.whitehouse.gov/omb/grants/grants_circulars.html.

1.03 The requirements and guidance in *Government Auditing Standards* apply to audits of governmental entities, programs, activities, and functions, and of governmental assistance administered by contractors, nonprofit entities, and other nongovernmental entities, when the use of *Government Auditing Standards* is required or is voluntarily followed. Entities for which an auditor may need to apply *Government Auditing Standards* when auditing financial statements include federal, state, and local governments, NPOs, health care organizations, and organizations with mortgage banking, real estate, or student lending and servicing activities. The Single Audit Act and Circular A-133 require the use of *Government Auditing Standards*. As discussed in chapter 5, "Overview of the Single Audit Act, Circular A-133, and the *Compliance Supplement*," of this guide, the Single Audit Act and Circular A-133 apply to nonfederal entities that expend \$500,000 or more of federal awards in a fiscal year. Other laws, regulations, agreements, contracts, or other authoritative sources could require the use of *Government Auditing Standards*. For example, state and local laws and regulations may require auditors of state and local governments to follow *Government Auditing Standards*. Federal audit guidelines pertaining to program requirements, such as those issued for Housing and Urban Development programs and Student Financial Aid programs, also may require the use of *Government Auditing Standards*.

1.04 This guide discusses the requirements of GAAS to the extent necessary to explain the related requirements of *Government Auditing Standards*. Auditors should refer to relevant professional standards and applicable Audit and Accounting Guides, such as *Health Care Organizations*, *Not-for-Profit Organizations*, and *State and Local Governments*, for additional information on GAAS requirements.

1.05 Paragraph .05 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), states that the auditing guidance included in this guide is an interpretive publication. Interpretive publications are not auditing standards. The guidance provides recommendations on the application of SASs to specific circumstances, in this case to audits performed in accordance with *Government Auditing Standards* and to single and program-specific audits under Circular A-133. The OMB, GAO, and AICPA promulgate applicable standards and requirements. Users of this guide should refer to those organizations' original standards and requirements.

1.06 In certain situations, *Government Auditing Standards* contain different requirements for internal audit organizations. For example, *Government Auditing Standards*, paragraph 5.18, footnote 69, does not require internal audit organizations to report fraud, illegal acts (violations of laws and regulations), violations of provisions of contracts or grant agreements, or abuse directly to parties outside the entity unless required by law, rule, regulation, or policy. This guide discusses the *Government Auditing Standards* relevant to independent auditors and does not highlight the different requirements for internal audit organizations. Internal audit organizations should refer to *Government Auditing Standards* for possible different requirements.

1.07 This guide is organized into 2 parts that discuss important considerations for audits under *Government Auditing Standards* and for single and program-specific audits under Circular A-133. Each part presents chapters with topics relating to planning, performing, evaluating the results of, and reporting on those audits. See the table of contents for the specific topics addressed in each part and chapter.

1.08 This guide is not a complete manual of procedures, and *Government Auditing Standards* states that the auditor must use professional judgment in planning and performing audit engagements and reporting the results. Because of the variety and complexity of the laws and regulations that govern audits performed under *Government Auditing Standards* and Circular A-133, the procedures included in this guide cannot cover all the circumstances or conditions that would be encountered in the audits of every entity. The auditor must use professional judgment to tailor procedures to meet the conditions of the particular engagement, so that the audit objectives may be achieved.

1.09 Certain states have imposed additional audit requirements related to state or local financial assistance. Further, pass-through entities may impose additional audit requirements on their subrecipients related to the financial assistance passed through. The guidance in this guide generally does not discuss or extend to those requirements.

Definitions

1.10 The terms used in this guide are intended to be consistent with the definitions in *Government Auditing Standards*, the Single Audit Act, and Circular A-133. Similarly, the term *not-for-profit organization* as used in this guide is consistent with the definition of the term *nonprofit organization* in Circular A-133 and includes not-for-profit institutions of higher education, hospitals, and other health care providers.

Adherence to Professional Standards and Requirements

1.11 AICPA Ethics Interpretation No. 501-3, "Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits," of Rule 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET sec. 501 par. .04), states that when an auditor undertakes an audit of government grants, government units, or other recipients of government monies 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 GAAS. An AICPA member auditor's failure to do so is an act discreditable to the profession and a violation of Rule 501 of the AICPA Code of Professional Conduct, unless the auditor's report discloses that those rules were not followed and the reasons therefore.

1.12 AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1), addresses the auditor's responsibilities when engaged to conduct an audit under *Government Auditing Standards* or the Single Audit Act and Circular A-133. Paragraph .21 of AU section 801 states that auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. The auditor should include a statement about the type of engagement and whether it is intended to meet specific audit requirements in a proposal, in a contract, or in the communication issued to establish an understanding with the auditee. (Chapter 2 of this guide further discusses the GAAS and *Government Auditing Standards* requirements for establishing an understanding with the auditee.)

1.13 Paragraph .21 of AU section 801 also states that management is responsible for obtaining audits that satisfy relevant legal, regulatory, or

contractual requirements. Paragraph .22 of AU section 801 states that GAAS do not require the auditor to perform procedures beyond those the auditor considers necessary to obtain sufficient appropriate audit evidence to form a basis for the opinion on the financial statements. However, if during a GAAS audit of the financial statements, the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and those charged with governance that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements. For example, the auditor will be required to make this communication if the auditor is engaged to perform an audit of an entity's financial statements in accordance with GAAS and the auditor becomes aware that, by law, regulation, or contractual agreement, the entity also is required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*
- The Single Audit Act and Circular A-133
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

1.14 Paragraph .23 of AU section 801 states that the required communication may be oral or written. If the communication is oral, the auditor should document the communication in the audit documentation. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including their potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), and AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1).

Part I

Government Auditing Standards *Audits*

Chapter 2

Planning Considerations of Government Auditing Standards

Note: *Government Auditing Standards* is periodically amended and codified. This guide includes guidance from the most recent revision of *Government Auditing Standards* issued July 2007, which was effective for financial audits, including financial statement audits, for periods beginning on or after January 1, 2008. Auditors who are performing audits conducted under the previous version of *Government Auditing Standards*, issued in 2003, can refer to the prior edition of this guide dated May 1, 2007, for the applicable guidance.

2.01 This chapter describes the requirements and guidance in *Government Auditing Standards* (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. Government Accountability Office (GAO), for audits of financial statements. In describing those requirements and guidance, this chapter also discusses planning considerations for those audits.¹ Auditors should refer to *Government Auditing Standards* for a complete discussion of the relevant requirements.

Overview

2.02 The professional standards and guidance for financial audits contained in *Government Auditing Standards* provide a framework for conducting high quality government audits with competence, integrity, objectivity and independence. *Government Auditing Standards* also emphasizes ethical principles as the foundation, discipline, and structure behind the implementation of the standards.

2.03 *Government Auditing Standards* uses two categories of professional requirements, identified by specific words, to describe the degree of responsibility they impose on auditors and audit organizations. Footnote 4 to paragraph 1.05 of *Government Auditing Standards* states the terminology used is intended to be consistent with AU section 120, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Unconditional requirements, which auditors are required to comply with, are indicated by the use of the words *must* or *is required*. Presumptively mandatory requirements are also required to be complied with. However, in rare circumstances auditors may depart from them provided they document their justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the

¹ AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), discusses the auditor's responsibilities for planning and supervision in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Various AICPA Audit and Accounting Guides, including *Health Care Organizations*, *Not-for-Profit Organizations*, and *State and Local Governments*, also discuss planning considerations for audits of financial statements performed under GAAS.

presumptively mandatory requirement. *Government Auditing Standards* uses the word *should* to specify a presumptively mandatory requirement. In December 2007, GAO issued *Government Auditing Standards: Implementation Tool – Professional Requirements Tool for Use in Implementing Requirements Identified by "Must" and "Should" in the July 2007 Revision of Government Auditing Standards* (GAO-08-210G, December 2007). This Professional Requirements Tool lists the requirements for audit organizations and auditors included in the July 2007 revision of *Government Auditing Standards*.

2.04 *Government Auditing Standards* also contains explanatory material which is intended to be descriptive rather than required. The words *may*, *might*, and *could* are used to provide further explanation and guidance on the professional requirements or to identify and describe other procedures or actions relating to the auditors' or audit organizations' activities. How and whether to carry out procedures or actions described in explanatory material depends on the exercise of professional judgment consistent with the objectives of the standard.

2.05 In conducting audits of financial statements in accordance with *Government Auditing Standards*, the auditor assumes certain responsibilities beyond those of audits performed in accordance with generally accepted auditing standards (GAAS). *Government Auditing Standards* describes ethical principles, establishes general standards, and establishes additional fieldwork and reporting standards beyond those required by GAAS. *Government Auditing Standards* requires additional reporting on internal control over financial reporting, compliance with laws, regulations, and provisions of contracts or grant agreements,² fraud, and abuse, which affect audit procedures performed. Specifically, in addition to an auditor's report that expresses an opinion or disclaimer of opinion on the financial statements as required by GAAS,³ a written report on internal control over financial reporting and on compliance and other matters is required under *Government Auditing Standards*. Chapters 4 and 5 further discuss the additional fieldwork and reporting responsibilities that specifically relate to internal control, compliance, fraud and abuse under *Government Auditing Standards*.

Relationship of Other Professional Standards and Government Auditing Standards

2.06 For financial audits, *Government Auditing Standards* incorporates the fieldwork and reporting standards of GAAS and the related Statements on

² Paragraph 4.28 footnote 59 of *Government Auditing Standards* and paragraph .02 of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1) defines the term *illegal acts* as violations of laws or governmental regulations. As indicated in chapter 3, "Financial Statement Audit Considerations of Government Auditing Standards," of this guide, it generally has been interpreted under GAAS that the term *laws and regulations* in AU section 317 implicitly includes provisions of contracts or grant agreements. This guide sometimes collectively refers to laws, regulations, and provisions of contracts and grant agreements as *compliance requirements* and to illegal acts and violations of provisions of contracts or grant agreements as *noncompliance* or *instances of noncompliance*.

³ As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government's basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. In addition, the auditor may provide opinions or disclaimers of opinions on additional opinion units if engaged to set the scope of the audit and assess materiality at a more detailed level than by the opinion units required for the basic financial statements. Throughout this guide, the use of the singular terms *opinion* and *disclaimer of opinion* encompasses the multiple opinions and disclaimers of opinion that generally will be provided on a government's financial statements.

Auditing Standards (SASs) issued by the AICPA unless specifically excluded or modified by *Government Auditing Standards*.⁴ In conducting audits of financial statements in accordance with *Government Auditing Standards*, the auditor should consider interpretive publications applicable to his or her audit, as discussed in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Interpretive publications other than this guide that affect the audits of financial statements of entities that are subject to *Government Auditing Standards* include the AICPA Audit and Accounting Guides, such as *Health Care Organizations*, *Not-for-Profit Organizations*, and *State and Local Governments*.⁵

2.07 Auditors may also use *Government Auditing Standards* in conjunction with Public Company Accounting Oversight Board⁶ or International Auditing and Assurance Standards Board standards even though those standards are not incorporated into *Government Auditing Standards*. (See paragraph 1.15 of *Government Auditing Standards*). Auditors may also cite the use of other standards in their audit reports, as appropriate. If the auditor is citing compliance with *Government Auditing Standards* and inconsistencies exist between *Government Auditing Standards* and other standards cited, the auditor should use *Government Auditing Standards* as the prevailing standard for conducting the audit and reporting the results.

Government Auditing Standards—Ethical Principles

2.08 *Government Auditing Standards* emphasizes the importance of ethical principles⁷ through a chapter devoted entirely to those principles. Chapter 2, "Ethical Principles in Government Auditing" begins by stating "Because auditing is essential to government accountability to the public, the public expects audit organizations and auditors who conduct their work in accordance with GAGAS (*Government Auditing Standards*) to follow ethical principles." While the five principles presented in the chapter do not contain additional requirements, they do provide a foundation for the audit organization and its

⁴ To date, the Comptroller General has not excluded any fieldwork or reporting standards or related Statements on Auditing Standards (SASs).

⁵ AICPA Audit and Accounting Guides that are cleared by a body designated by the AICPA Council to establish accounting principles also constitute category (b) generally accepted accounting principles (GAAP). See AU section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1).

⁶ Some entities are required to have an audit conducted in accordance with standards issued by both the Public Company Accounting Oversight Board (PCAOB), as required by the Sarbanes-Oxley Act of 2002, and the Comptroller General, as contained in *Government Auditing Standards* (the Yellow Book). Some examples include lending institutions that participate in federally sponsored loan programs such as housing and education. The Government Accountability Office (GAO) has issued guidance on the Yellow Book page of its Web site at www.gao.gov/govaud/ybk01.htm titled "Guidance on Complying with *Government Auditing Standards* Reporting Requirements for the Report on Internal Control for Audits of Certain Entities Subject to the Requirements of the Sarbanes-Oxley Act of 2002 and *Government Auditing Standards*." This GAO guidance states that it recognizes that the use of PCAOB's framework for assessing control deficiencies could result in inconsistencies in reporting on internal control under the Yellow Book. Guidance is available to facilitate the reporting of internal control deficiencies identified during audits conducted under both PCAOB and Yellow Book standards, to ensure the consistency of information included in the Yellow Book report on internal control, and to assist auditors in complying with Yellow Book standards. See the GAO Web site for further information.

⁷ The bylaws of the AICPA require its members to adhere to the Code of Professional Conduct. The code consists of two sections, the Principles and the Rules. The Principles provide the framework for the Rules, which govern the performance of professional services by members. *Code of Professional Conduct* (AICPA, *Professional Standards*, vol. 2, ET sec.).

auditors in applying ethical principles to government audits. The five ethical principles are as follows:

1. The public interest
2. Integrity
3. Objectivity
4. Proper use of government information, resources, and position
5. Professional behavior

These principles help guide the work of auditors who conduct audits in accordance with *Government Auditing Standards* and provide the overall framework for the application of *Government Auditing Standards*, including general standards, fieldwork standards and reporting standards. See chapter 2 of *Government Auditing Standards* for a full discussion of these principles.

Government Auditing Standards—General Standards

2.09 The general standards found in chapter 3 of *Government Auditing Standards*, along with the overarching ethical principles found in chapter 2, establish a foundation for credibility of auditor's work. The general standards applicable to *Government Auditing Standards* are as follows:

- In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be free from personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments of independence (independence standard).
- Auditors must use professional judgment in planning and performing audits and in reporting the results (professional judgment standard).
- The staff assigned to perform the audit must collectively possess adequate professional competence for the tasks required (competence standard).
- Each audit organization performing audits in accordance with *Government Auditing Standards* must (a) establish a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and (b) have an external peer review at least once every three years (quality control and assurance standard).

Independence

2.10 In a GAAS audit, members are required to comply with the AICPA's Code of Professional Conduct Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101). For audits conducted in accordance with *Government Auditing Standards*, auditors and audit organizations are subject to additional independence rules that are in some cases very similar to the AICPA independence rules and in other cases more restrictive. *Government Auditing Standards* employs a principles based approach to independence supplemented with certain safeguards for matters such as the performance of nonaudit services. *Government Auditing Standards* states that auditors and audit organizations must be free from personal, external, and organizational impairments

to independence and must avoid the appearance of such impairments of independence. If an audit organization is not independent, *Government Auditing Standards* states that the auditor (a) should decline to perform the work or (b) must disclose the impairment and modify the compliance statement in the auditor's report when a government auditor cannot decline to perform the work because of a legislative requirement or for other reasons.⁸ (See also paragraph 4.22 footnote 20). The remainder of this section of the guide highlights the *Government Auditing Standards* independence requirements.

2.11 Auditors and audit organizations must maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and viewed as impartial by objective third parties with knowledge of the relevant information. The independence rules in chapter 3 of *Government Auditing Standards* address when auditors and their organizations are independent from the organizations they audit by defining when any of the three general classes of impairments (personal, external, and organizational) to independence exist.^{9,10} *Government Auditing Standards* adopts an engagement team-focused approach to independence for matters such as financial interests of an individual auditor, not unlike the AICPA's Code of Professional Conduct. Audit organizations should include as part of their quality control system procedures to identify and resolve personal impairments and help ensure compliance with *Government Auditing Standards* independence requirements. In addition, audit organizations should maintain documentation of the steps taken to identify potential personal independence impairments.

2.12 Paragraph 3.05 of *Government Auditing Standards* states that when auditors use the work of a specialist, auditors should assess the specialist's ability to perform the work and report results impartially as it relates to their relationship with the program or entity under audit. If the specialist's independence is impaired, auditors should not use the work of that specialist.

2.13 In planning the audit, the auditor should consider the effects of any nonaudit services performed on the auditor's independence for current, future and planned audit service. Audit organizations may perform other professional services (nonaudit services) that are not performed in accordance with *Government Auditing Standards*. In that case, audit organizations must evaluate whether providing the nonaudit services creates an independence impairment either in fact or appearance with respect to the entities it audits. Two overarching principles apply to auditor independence when assessing the impact of performing a nonaudit service to an audited program or entity. The first states that audit organizations must not provide nonaudit services that involve performing management functions or making management decisions. The second

⁸ Paragraph 3.06 of *Government Auditing Standards* explains what action should be taken in the case where an impairment to independence is identified after the audit report is issued. Any related notification to management, those charged with governance, regulatory agencies and others should be made in writing.

⁹ The GAO has issued a question and answer document titled *Answers to Independence Standard Questions*, which responds to questions related to the independence standard's implementation time frame, underlying concepts, and application in specific nonaudit circumstances. That document is on the Yellow Book page of the GAO's Web site at www.gao.gov/govaud/ybk01.htm. A document that references the information in the publication *Answers to Independence Standard Questions* to the 2007 revision of *Government Auditing Standards* is also available on the GAO Web site.

¹⁰ *Government Auditing Standards* also provides criteria for when governmental audit organizations are organizationally independent from the auditee for purposes of external and internal reporting.

one states that audit organizations must not audit their own work or provide nonaudit services in situations in which the nonaudit services are significant or material to the subject matter of the audits.¹¹

2.14 *Government Auditing Standards* states that nonaudit services provided to entities it audits generally fall into three categories:¹²

- Nonaudit services that do not impair an audit organization's independence and therefore do not require compliance with supplemental safeguards. (Paragraphs 3.26–.27 of *Government Auditing Standards*)
- Nonaudit services that would not impair an audit organization's independence as long as the audit organization complies with the supplemental safeguards described in paragraph 2.15. (Paragraph 3.28 of *Government Auditing Standards*)
- Nonaudit services that do impair an audit organization's independence. Compliance with the supplemental safeguards will not overcome this impairment. (Paragraph 3.29 of *Government Auditing Standards*)

2.15 Performing nonaudit services described in paragraph 3.28 of *Government Auditing Standards* will not impair independence if the overarching principles described in paragraph 2.13 are not violated and the supplemental safeguards described in chapter 3 of *Government Auditing Standards* are implemented. For this category of nonaudit services the audit organization should comply with each of the following safeguards:

- Document its consideration of the nonaudit services, including its conclusions about the impact on independence.
- Establish in writing an understanding with the audited entity regarding the objectives, scope of work, and product or deliverables of the nonaudit service and management's responsibility for (1) the subject matter of the nonaudit services, (2) the substantive outcomes of the work, and (3) making any decisions that involve management functions related to the nonaudit service and accepting full responsibility for such decisions.
- Exclude personnel who provided the nonaudit services from planning, conducting, or reviewing audit work in the subject matter of the nonaudit service.^{13, 14}
- Do not reduce the scope and extent of the audit work below the level that would be appropriate if the nonaudit service were performed by an unrelated party.

¹¹ Paragraph 3.22 footnote 28 of *Government Auditing Standards* states that the concepts of significance and materiality include quantitative as well as qualitative measures in relation to the subject matter of the audit.

¹² Appendix I paragraphs A3.02 and A3.03 of *Government Auditing Standards* provide examples of nonaudit services that are generally unique to audit organizations in government entities.

¹³ Personnel who provided the nonaudit service are permitted to convey to the audit team the documentation and knowledge gained about the audited entity and its operations.

¹⁴ As stated in Question 30 of the GAO publication *Answers to Independence Standard Questions*, in applying the safeguards and for reasons of efficiency and practicality, if the nonaudit service involves a total of 40 hours or fewer as it relates to a specific audit engagement, the safeguard associated with precluding personnel who provided the nonaudit service from performing related audit work

(continued)

Professional Judgment

2.16 *Government Auditing Standards* states that auditors must use professional judgment in planning and performing audits and in reporting the results. While this standard is similar to the AICPA standard on due professional care in AU section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol.1), *Government Auditing Standards* expands the discussion of professional judgment as it relates to its importance in audit engagements. Professional judgment includes exercising reasonable care and professional skepticism. Reasonable care concerns acting diligently in accordance with professional standards and ethical principles. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of evidence. Auditors should document significant decisions affecting the audit objectives, scope, and methodology, findings, conclusions, and recommendations resulting from professional judgment.

2.17 Chapter 3 of *Government Auditing Standards* provides further guidance regarding the use of professional judgment in the audit process. Items that are among those described by *Government Auditing Standards* are as follows:

- A critical component of an audit is the use of the auditor's professional knowledge, skills, and experience to diligently perform, in good faith and with integrity, the gathering of information and the objective evaluation of the sufficiency and appropriateness of evidence.
- Professional judgment represents the application of the collective knowledge, skills, and experiences of all the personnel involved with an assignment, as well as the professional judgment of individual auditors. Using professional judgment on all aspects of carrying out their professional responsibilities, including following the independence standards, maintaining objectivity and credibility, assigning competent audit staff, defining the scope of work, evaluating and reporting the results of the work, and maintaining appropriate quality control over the assignment process is essential to performing and reporting on an audit.
- Using professional judgment is important in determining the required level of understanding of the audit subject matter and related circumstances. This includes consideration about whether the audit team's collective experience, training, knowledge, skills, abilities, and overall understanding are sufficient to assess the risks that the subject matter under audit may contain a significant inaccuracy or could be misinterpreted.
- Considering the risk level of each assignment, including the risk that they may come to an improper conclusion is another important issue. In this context, exercising professional judgment in determining the sufficiency and appropriateness of evidence to be used to support the findings and conclusions based on the audit objectives and any recommendations reported is an integral part of the audit process.

(footnote continued)

would not be required. However, the other safeguards described in this paragraph would apply. Auditors and audit organizations need to consider related services that may have been performed under separate contracts or separate engagements in applying this de minimis criteria.

Competence

2.18 *Government Auditing Standards* states that the staff assigned to perform the audit must collectively possess adequate professional competence for the tasks required.¹⁵ *Government Auditing Standards* is generally consistent with the AICPA's general standard on auditor qualification in AU section 210, *Training and Proficiency of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1). *Government Auditing Standards* states that an audit organization should have a process for recruitment, hiring, continuous development, assignment, and evaluation of staff to maintain a competent workforce. One of the areas that process should address is continuing professional education (CPE).

2.19 Auditors performing work under *Government Auditing Standards*, including planning, directing, performing field work, or reporting on an audit engagement, should maintain their professional competence through CPE. Therefore, each auditor performing work under *Government Auditing Standards* should complete, every 2 years, at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates. Those auditors who are involved in any amount of planning, directing, or reporting on assignments using *Government Auditing Standards* and those auditors who are not involved in those activities but charge 20 percent or more of their time annually to *Government Auditing Standards* related engagements should also obtain at least an additional 56 hours of CPE (for a total of 80 hours of CPE in every 2 year period) that enhances the auditor's professional proficiency to perform audits or attestation engagements. At least 20 of the 80 hours should be completed in any one year of the two-year period. *Government Auditing Standards* also states that the audit organization should have quality control procedures to help ensure that auditors meet the continuing education requirements, including documentation of the CPE completed.

2.20 The GAO has issued *Guidance on GAGAS Requirements for Continuing Professional Education*¹⁶ which provides additional guidance to auditors and audit organizations in implementing the CPE requirements prescribed by *Government Auditing Standards*. Among other things, the guidance discusses who is subject to the CPE requirements; the programs, activities, subjects and topics that qualify as acceptable CPE; how compliance with CPE requirements is measured; how to measure CPE hours; and how CPE requirements are to be administered. The guidance also states that auditors hired or assigned to a *Government Auditing Standards* audit engagement after the beginning of an audit organization's 2-year CPE period should complete a prorated number of CPE hours.

2.21 *Government Auditing Standards* does not require external specialists to meet its CPE requirements, but states that they should be qualified and

¹⁵ Paragraph 3.42 of *Government Auditing Standards* provides a listing of the types of technical knowledge and skills that staff members should collectively possess. In addition, auditors performing financial audits should be knowledgeable in GAAP, the AICPA standards of fieldwork and reporting, and the related SASs and their application. If another set of standards is used in conjunction with *Government Auditing Standards*, the auditor should be knowledgeable and competent in applying those standards.

¹⁶ This guidance, *Government Auditing Standards: Guidance on GAGAS Requirements for Continuing Professional Education*, GAO-05-568G (Washington, D.C., April 2005), can be found on the Yellow Book page of the GAO's Web site at www.gao.gov/govaud/ybk01.htm.

maintain professional competence in their areas of specialization. Auditors who use the work of external specialists should assess the professional qualifications and document their findings and conclusions. Internal specialists who are part of the audit organization and perform as a member of the audit team should comply with *Government Auditing Standards*, including the CPE requirements.

Quality Control and Assurance

2.22 Each audit organization¹⁷ performing audits in accordance with *Government Auditing Standards* must (1) establish a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and (2) have an external peer review at least once every three years.¹⁸ Paragraphs 3.50–.63 of *Government Auditing Standards* address the general standard for quality control and assurance, including a listing of policies and procedures that should be addressed in the quality control system. The audit organization must document its quality control procedures and communicate the policies and procedures to its personnel. The audit organization also should document compliance with its quality control policies and procedures and should maintain the documentation for a period of time sufficient to enable those performing monitoring procedures and peer reviews to evaluate the extent of the audit organization's compliance with its quality control policies and procedures. The audit organization should analyze and summarize the results of its monitoring procedures at least annually including identification of any systemic improvements and recommendations for corrective action.

2.23 *Government Auditing Standards* also contains requirements related to external peer review. Audit organizations performing audits in accordance with *Government Auditing Standards* must have an external peer review performed by reviewers independent of the audit organization being reviewed at least once every three years.¹⁹ The external peer review should be sufficient in scope to provide a reasonable basis for determining whether the reviewed audit organization's internal quality control system was suitably designed and whether the audit organization is complying with its quality control policies and procedures. Paragraphs 3.57–.63 of *Government Auditing Standards* contain guidance for the peer review team in conducting a review.

2.24 An audit organization seeking to enter into a contract to perform an engagement in accordance with *Government Auditing Standards* should provide their most recent external peer review report and any letter of comment

¹⁷ The Auditing Standards Board of the AICPA issue Statements of Quality Control Standards that must be adhered to by firms that are enrolled in an Institute-approved practice-monitoring program.

¹⁸ *Government Auditing Standards* provides that audit organizations have an external peer review conducted within three years from the date of the start of field work of their first assignment in accordance with *Government Auditing Standards*. Subsequent external peer reviews should be conducted every three years. Extensions of the deadlines for submitting the peer review report exceeding three months beyond the due date are granted by the entity that administers the peer review program and GAO.

¹⁹ An audit organization's noncompliance with the external peer review requirement (paragraph 3.50b of *Government Auditing Standards*), results in a modified *Government Auditing Standards* compliance statement. However, the organization's compliance or noncompliance with the requirements for a system of Quality Control are tested and reported on as a part of the peer review process and do not impact the *Government Auditing Standards* compliance statement.

to the party contracting for the audit. They also should provide subsequent reports and letters received during the period of the contract to that party. Also, an external audit organization (as defined in paragraphs 3.13–.15 of *Government Auditing Standards*) should make its most recent peer review report publicly available (for example, on an external Web site or a publicly available file designed for public transparency of peer review results). If these options are not available to the audit organization, it should use the same transparency mechanism it uses to make other information public, and also provide the peer review report to others upon request. Government audit organizations should also communicate the overall results and the availability of their external peer review reports to appropriate oversight bodies. Auditors who are relying on another audit organization's work should request a copy of that organization's peer review report and any letter of comment, and that audit organization should provide the documents when requested. This guide recommends that auditors consider including information about requests for other organizations' reports and letters and the receipts and provision of reports and letters in the audit documentation.

Government Auditing Standards—Fieldwork Standards

2.25 *Government Auditing Standards* incorporate the AICPA fieldwork standards and the related SASs into its standards by reference. The AICPA fieldwork standards, as found in AU section 150 are as follows:

- The auditor must adequately plan the work and must properly supervise any assistants.
- The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
- The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

2.26 In addition to the AICPA standards, *Government Auditing Standards* establishes additional fieldwork standards for auditors to comply with when citing *Government Auditing Standards* in their audit reports. These additional standards relate to

- auditor communication during planning.
- previous audits and attestation engagements.
- detecting material misstatements resulting from violations of provisions of contracts or grant agreements, or from abuse.
- developing elements of a finding.
- audit documentation.

Auditor Communication

2.27 *Government Auditing Standards* states that the auditor should communicate with the audited entity their understanding of the services to be performed and document that understanding through a written communication. This information regarding the nature, timing, and extent of planned testing and reporting and the level of assurance to the parties identified in

paragraph 2.29 is part of the planning stages of an audit. (See paragraphs 2.40–.41 for a discussion of the GAAS guidance as found in AU section 311, *Planning and Supervision* [AICPA, *Professional Standards*, vol. 1], related to this communication.)

2.28 *Government Auditing Standards* paragraphs 4.05–.08 broaden both the parties included in the communication and the information to be communicated. *Government Auditing Standards* states that the required auditor communication should include the following additional information:

- The nature of planned work and level of assurance to be provided related to internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreement
- Potential restrictions on the auditor's reports

The discussion in paragraph 4.07 of *Government Auditing Standards* may be helpful to auditors in explaining their responsibilities for testing and reporting on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements.

2.29 *Government Auditing Standards* also broadens the parties included in the communication. The auditor should communicate the required information to the following:

- Management and those charged with governance (which normally would include the head of the organization, the audit committee or board of directors or other equivalent oversight body in the absence of an audit committee, and the individual who possesses a sufficient level of authority such as the chief financial officer)
- The individuals contracting for or requesting the audit services, in situations where the auditor is performing the audit under a contract with a party other than the auditee, or pursuant to a third-party request
- The legislative members or staff who have oversight of the auditee—when the auditor is performing the audit pursuant to a law, regulation or contract with the specific legislative committee (This applies only to situations where the law or regulation specifically identifies the entity to be audited. It is not applicable to situations where the mandate to audit the financial statements applies to entities not specifically identified, such as audits required by the Single Audit Act.)

2.30 *Government Auditing Standards* also states that if an audit is terminated before it is complete, and an audit report is not issued, auditors should document the results of the work to the date of termination and explain the reasons why the audit was terminated. Determining whether and how to communicate the reason for terminating the audit to those charged with governance, appropriate officials of the audited entity, the entity contracting for the audit, and other appropriate officials will depend on the facts and circumstances, and is a matter of professional judgment.

Considering the Results of Previous Audits and Attestation Engagements

2.31 Paragraph 4.09 of *Government Auditing Standards* states that auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements. As part of planning, auditors should ask management of the audited entity to identify any recommendations from previous audits, attestation engagements and other studies that relate to the audit objectives, and whether those recommendations have been implemented. This information should be used in assessing risk and determining the nature, timing, and extent of current audit work, including determining the extent to which testing the implementation of the corrective actions is applicable to the current audit objectives.²⁰

Detecting Material Misstatements Resulting From Violations of Provisions of Contracts and Grant Agreements and Abuse

2.32 *Government Auditing Standards* contains an additional fieldwork standard which states that auditors should design the audit to provide reasonable assurance of detecting misstatements resulting from violations of provisions of contracts or grant agreements and that could have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.²¹ However, it generally has been interpreted under GAAS that the phrase *laws and regulations* in AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), implicitly includes provisions of contracts or grant agreements. Thus, the auditor's responsibility in an audit of financial statements with regard to detecting material misstatements resulting from violations of provisions of contracts or grant agreements under *Government Auditing Standards* equates to the auditor's responsibility under GAAS. Chapter 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide further discusses this issue and related auditing procedures.

2.33 Paragraphs 4.12–.13 of *Government Auditing Standards* contains a discussion of abuse and its potential effect on audits of financial statements. Chapter 3 of this guide discusses the standard concerning abuse and related auditing procedures.

Developing Elements of a Finding

2.34 *Government Auditing Standards* discusses audit findings, which may involve deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse. When auditors identify deficiencies, they should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. *Government Auditing Standards* discusses the elements of an audit finding in

²⁰ Circular A-133 contains additional requirements for follow-up on prior audit findings. See chapters 10, "Compliance Auditing Applicable to Major Programs," and 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide.

²¹ The reference in *Government Auditing Standards* to "other financial data significant to the audit objectives" relates to auditing procedures on financial data outside of the basic financial statements. For example, it may relate to required supplementary information (RSI) and supplementary information other than RSI (known as SI). It also relates to financial audits other than the audits of financial statements, including audits conducted in accordance with Circular A-133.

paragraphs 4.15–18. They are criteria, condition, cause, and effect (or potential effect). Chapter 4 of this guide further discusses audit findings as they relate to *Government Auditing Standards*.

Audit Documentation

2.35 AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), states that an auditor must prepare audit documentation in sufficient detail to provide a clear understanding of the work performed, the audit evidence obtained and its source, and the conclusions reached. The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand the nature, timing, extent, results, and conclusions of auditing procedures performed, and that the accounting records agree or reconcile with the audited financial statements or other audited financial information. AU section 339 contains guidance on: documenting significant findings or issues; identifying the preparer and reviewer of audit documentation; documenting specific items tested; documenting departures from relevant SASs; revising audit documentation after the date of the auditor's report; and ownership and confidentiality of audit documentation. Also, auditors should complete audit documentation within 60 days of, and retain documentation for at least five years from, the audit report release date. Documentation must not be deleted or discarded during this retention period. However, certain additions made in accordance with AU section 339 may be made to the documentation after the report release date or the documentation completion date. See also appendix A, "Audit Documentation Requirements in Other Statements on Auditing Standards," in AU section 339.

2.36 In addition to the requirements found in AU section 339, *Government Auditing Standards* discusses several other issues related to audit documentation. *Government Auditing Standards* states that before the report is issued, auditors should document evidence of supervisory review of the work performed that supports findings, conclusions, and recommendations contained in the audit report. Also, any departure from *Government Auditing Standards* requirements due to law, regulation, scope limitations, restrictions on access to records, or other issues impacting the audit should be documented along with the impact on the audit and the auditors' conclusions. This applies to both mandatory and presumptively mandatory requirements.

2.37 *Government Auditing Standards* states that policies and procedures should be established for the safe custody and retention of audit documentation for a time sufficient to satisfy legal, regulatory, and administrative requirements for record retention. When audit documentation is retained electronically, the audit organization should establish information systems controls concerning accessing and updating the audit documentation. Policies and procedures should also be developed to deal with requests by outside parties to obtain access to audit documentation, especially when an outside party attempts to obtain information indirectly through the auditor rather than directly from the audited entity.

2.38 *Government Auditing Standards* contains a discussion of auditors using the work of other auditors to avoid duplication of efforts in auditing programs of common interest. Cooperation between parties is encouraged. Auditors should make appropriate individuals, and audit documentation, available upon request (subject to applicable laws and regulations) and in a timely manner to other auditors or reviewers. This may be facilitated by contractual

arrangements for *Government Auditing Standards* audits that provide for full and timely access to appropriate individuals and audit documentation.

2.39 This chapter of the guide discusses specific additional audit documentation requirements of *Government Auditing Standards*. The documentation requirement and the paragraph where it is discussed is summarized as follows:

- Assurance obtained that specialists used are qualified (paragraph 2.21)
- Steps taken to identify potential personal independence impairments (paragraph 2.11)
- Consideration of providing nonaudit services, including its conclusion about the impact on independence (paragraph 2.13)
- Significant decisions affecting the audit objectives, scope, and methodology, findings, conclusions, and recommendations resulting from professional judgment (paragraph 2.16)
- CPE completed (paragraph 2.19)
- Quality control policies and procedures (paragraph 2.22)
- Evidence of supervisory review, prior to the date the audit report is issued, of the audit work performed that supports findings, conclusions, and recommendations contained in the audit report (paragraph 2.36)
- Communication with the auditee or others regarding the nature, timing, and extent of planned testing and reporting and the level of assurance (paragraph 2.27)
- Communication with the auditee or others regarding the reasons for terminating an audit (paragraph 2.30)

Additional Planning Considerations

Establishing an Understanding With the Auditee

2.40 AU section 311 states that the auditor should establish an understanding with the auditee regarding the services to be performed for each engagement. Such understanding reduces the risk that either the auditor or the auditee may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement. The auditor should communicate this information in the form of an engagement letter. If the auditor believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.

2.41 Paragraph .09 of AU section 311 presents a listing of the matters that are generally included when the auditor establishes an understanding with the auditee regarding an audit of the financial statements. In addition to those matters, the auditor may also consider including the following information in the communication when he or she is engaged to perform an audit of financial statements in accordance with *Government Auditing Standards*:

- A description of the financial statements to be audited
- The reporting period

- The auditing standards and requirements that will be followed (that is, GAAS and *Government Auditing Standards*)
- A description of management's responsibility²² for the following:
 - Reviewing, approving, and taking responsibility for the financial statements and related notes and for acknowledging the auditor's role if the auditor has a role in preparing the trial balance and draft financial statements and related notes or in converting cash-basis financial statements to accrual-based financial statements²³
 - Taking timely and appropriate steps to remedy fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that the auditor reports
 - Establishing and maintaining effective internal control to help ensure that appropriate goals and objectives are met, and ensuring that management and financial information is reliable and properly recorded.
 - Identifying for the auditor previous financial audits, attestation engagements, performance audits, or other studies related to the objectives of the audit being undertaken and the corrective actions taken to address significant findings and recommendations
 - Providing views on the auditor's current findings, conclusions, and recommendations, as well as management's planned corrective actions, for the report, and the timing and format for providing that information
- A description of management and auditor responsibilities for additional information that accompanies the basic financial statements—required supplementary information (RSI) and supplementary information other than RSI (known as SI)
- A statement that because the determination of abuse is subjective, *Government Auditing Standards* does not expect auditors to provide reasonable assurance of detecting abuse
- The communication with the auditee, the individuals contracting for or requesting audit services, and those charged with governance required by *Government Auditing Standards* and discussed in paragraphs 2.27–.29
- A description of the reports the auditor is expected to prepare and issue
- Report distribution responsibilities, including that copies are available for public inspection unless the report is restricted by

²² Appendix I of *Government Auditing Standards*, section A1.08, *Management's Role in Accountability*, contains an expanded list of responsibilities.

²³ As indicated in paragraph 3.28a of *Government Auditing Standards*, a management representation as to management's responsibility for this work should be obtained. To ensure that the auditee is in a position to make the required representation, the auditor may wish to include in the communication that establishes an understanding with the auditee the specific steps the auditee will take, which may include designating a qualified management-level individual to be responsible and accountable for overseeing the drafting or conversion of the financial statements.

law or regulation, or contains privileged and confidential information

- A statement that the audit documentation will be made available upon request to appropriate auditors and reviewers
- A copy of the audit organization's most recent external peer review report and any letter of comment as discussed in paragraph 2.24

Audit Materiality Considerations

2.42 AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on the auditor's consideration of materiality when he or she plans and performs an audit of financial statements in accordance with GAAS. Materiality, as it relates to the financial statement audit, is further discussed in the AICPA Audit and Accounting Guides, including *Not-for-Profit Organizations* and *State and Local Governments*.²⁴

2.43 Chapter 4 of *Government Auditing Standards* contains guidance on materiality considerations. As noted in paragraph 4.26 footnote 55 of *Government Auditing Standards*, according to AU section 312, the consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of the users of the financial statements. Paragraph 4.26 of *Government Auditing Standards* states "For example, in audits performed in accordance with *Government Auditing Standards*, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-*Government Auditing Standards* audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs."

Determining Compliance Requirements

2.44 In planning the consideration of the internal control and compliance aspects of the audit, the auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that will have a direct and material effect on the determination of amounts in the entity's financial statements. The auditor should also assess whether management has identified all the laws and regulations that have a direct and material effect on the financial statements. As discussed in footnote 2 at paragraph 2.05 the term *laws and regulations* includes *provisions of contract and grant agreements* when considering compliance. Chapter 3 of this guide discusses possible audit procedures to assess the completeness of management's identification of compliance requirements.

Joint Audits

2.45 Because governmental entities and entities that receive governmental assistance often have legal or contractual requirements to make positive

²⁴ As discussed in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor's consideration of materiality for purposes of planning, performing, evaluating the results of, and reporting on the audit of the financial statements of a state or local government is based on opinion units. See that guide for further guidance.

efforts to use small business, minority-owned firms, and women's business enterprises, they may engage such independent accounting firms on a joint-venture or subcontract basis. In these instances it may be necessary to refer to the work of other auditors. AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1), and Ethics Interpretation No. 101-10, "The effect on independence of relationships with entities included in the governmental financial statements," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .12), provides guidance for the principal auditor prior to entering into an agreement to perform a joint audit or to subcontract with another firm. The principal auditor should be satisfied that the other auditors meet the general standards of *Government Auditing Standards*, as discussed in paragraphs 2.09–.24. (See also chapter 4 for additional reporting considerations relating to other auditors).

2.46 In some circumstances, each of the auditors participating in the audit will jointly sign the audit reports. This is appropriate only when each auditor or firm has complied with GAAS and *Government Auditing Standards* and is in a position that would justify being the only signatory of the report.

The Internal Audit Function

2.47 Another factor the auditor may need to consider when planning the audit is whether the auditee has an internal audit function and the nature of that function, including the extent to which internal auditors are involved in monitoring internal control and compliance with specified requirements. AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), provides guidance when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters (for example, in obtaining an understanding of the entity's internal control over financial reporting and compliance, assessing audit risk, and performing substantive procedures). See also paragraphs 3.16–.19 of *Government Auditing Standards* for a discussion of independence as it relates to internal audit functions.

Communications With Other Entities

2.48 When professional judgment indicates it is appropriate, the auditor may communicate with grantor agencies (including pass-through entities) or federal or state auditors or other oversight entities to aid in planning the audit. As part of establishing the overall audit strategy, the auditor should document such communications, as well as any decisions reached as a result. If a planning meeting is held, matters such as the following may be discussed:

- The audit plan
- The scope of the review and testing of internal control over financial reporting and of compliance
- The identification of grant awards and compliance requirements, including current year changes to those requirements
- The form and content of required supplemental reporting
- The status of prior-year findings and recommendations
- Recent audits or other reviews conducted by federal or state auditors or other oversight entities

Exit Conference

2.49 Upon completion of fieldwork, the auditor may hold a closing or exit conference with senior officials of the auditee. The exit conference assists the auditor in obtaining the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective action, as required by *Government Auditing Standards*. (Chapter 4 of this guide discusses that *Government Auditing Standards* requirement and its guidance when auditee comments are received orally rather than in writing. *Government Auditing Standards* states that obtaining the comments in writing is preferred, but oral comments are acceptable.) That conference also provides the auditee with an advance opportunity to discuss whether planned corrective actions adequately address the auditor's recommendations and to initiate corrective action without waiting for a final audit report. In the case of decentralized operations, such as at a university, auditors may consider having preliminary meetings with deans, department heads, and other operating personnel who have direct responsibility for financial management systems and the administration of sponsored projects.

2.50 The auditor may also consider documenting the names of the auditors who conducted the exit conference, the names and positions of the representatives with whom exit conferences were held and any comments that they had, and other details of the discussions.

Chapter 3

Financial Statement Audit Considerations of Government Auditing Standards

Introduction

Note: *Government Auditing Standards* is periodically amended and codified. This guide includes guidance from the most recent revision of *Government Auditing Standards* issued July 2007, which was effective for financial audits, including financial statement audits, for periods beginning on or after January 1, 2008. Auditors who are performing audits conducted under the previous version of *Government Auditing Standards*, issued in 2003, can refer to the prior edition of this guide dated May 1, 2007, for the applicable guidance.

3.01 This chapter summarizes the requirements of generally accepted auditing standards (GAAS) related to the auditor's consideration of internal control over financial reporting and financial statement misstatements, including misstatements relating to compliance, in a financial statement audit. As discussed in chapter 2, "Planning Considerations of *Government Auditing Standards*," of this guide, *Government Auditing Standards* incorporates those GAAS requirements.¹ This chapter also discusses the additional requirements of *Government Auditing Standards* in those areas and in the area of abuse.

Consideration of Internal Control Over Financial Reporting

3.02 The following paragraphs describe the requirements of GAAS and *Government Auditing Standards* applicable to the auditor's consideration of internal control over financial reporting in a financial statement audit.²

GAAS Requirements

3.03 The AICPA's second standard of fieldwork states that the auditor must obtain a sufficient understanding of the entity and its environment,

¹ *Government Auditing Standards* incorporates the fieldwork and reporting standards of generally accepted auditing standards (GAAS) and the related Statements on Auditing Standards (SASs) issued by the AICPA unless the Comptroller General of the United States excludes them by formal announcement. To date, the Comptroller General has not excluded any fieldwork or reporting standards or related SASs.

² When discussing internal control, the risk assessment suite of standards (SAS Nos. 104–111) also includes a detailed discussion of understanding the entity and its environment and assessing the risks of material misstatement. Since this chapter is intended to focus on explaining the auditing requirements of *Government Auditing Standards*, it does not present full coverage of the risk assessment standards. Auditors should refer to relevant professional standards and applicable Audit and Accounting Guides, such as *Health Care Organizations*, *Not-for-Profit Organizations*, and *State and Local Governments*, and the Audit Guide *Assessing and Responding to Audit Risk in A Financial Statement Audit*, which include more detailed coverage of the risk assessment standards. See also the notice to readers section of this guide entitled "Effect of Risk Assessment Standards on the Guide" for additional explanation of the incorporation of the risk assessment standards in this guide.

including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The guidance found in AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), discusses the scope of understanding that the auditor must obtain relating to "the entity and its environment, including internal control." In accordance with paragraph .04 of AU section 314, the auditor should use professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (1) to assess risks of material misstatement of the financial statements and (2) to design and perform further audit procedures (tests of controls and substantive tests). The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatements of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

The auditor should perform the risk assessment procedures found in paragraph .06 of AU section 314 to obtain an understanding of the entity and its environment, including its internal control. These procedures include inquiries of management and others within the entity, analytical procedures, observation, and inspection. Furthermore, obtaining this understanding is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. (Appendix A of AU section 314 contains examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment.)

3.04 While all the previously mentioned items are important to consider in an audit of financial statements, this section focuses on the topic of internal control, which is especially important in an audit of financial statements under *Government Auditing Standards* since it requires auditor reporting related to internal control over financial reporting. When obtaining an understanding of internal control over financial reporting, the auditor should refer to AU section 314 and to guidance in applicable AICPA Audit and Accounting Guides.³

Definition of Internal Control

3.05 The definition of *internal control* in AU section 314 is based on the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The definition is as follows:

³ Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units, the auditor's consideration of internal control over financial reporting in planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements should address each opinion unit. See that guide for further guidance.

Internal control is a process—effected by those charged with governance, management and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives in the following categories:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

Control Objectives

3.06 There is a direct relationship between an entity's objectives and the internal control components it implements to provide reasonable assurance about their achievement. Although the entity's objectives, and therefore controls, relate to financial reporting, operations, and compliance, not all of these objectives and controls are relevant to the audit of the financial statements. Furthermore, although internal control applies to the entire entity, an understanding of internal control relating to each of the programs or business functions may not be necessary to the performance of the audit. In general, controls that are relevant to an audit of financial statements pertain to the auditee's objective of the reliability of financial reporting and involve the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles (GAAP) or a comprehensive basis of accounting other than GAAP,⁴ including controls that are relevant to the management of risk that may give rise to a risk of material misstatement in those financial statements. However, controls pertaining to the operations and compliance objectives may be relevant to an audit to the extent that they pertain to data the auditor may evaluate or use in applying auditing procedures to the financial statements. Controls relevant to an audit of the financial statements are referred to collectively in this guide as *internal control over financial reporting* and are encompassed in the reporting on internal control required by *Government Auditing Standards*, as discussed in chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide.

Components of Internal Control

3.07 The five components of internal control are the control environment, risk assessment, information and communications, control activities and monitoring. The division of internal control into the five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. The division does not necessarily reflect

⁴ AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), defines the comprehensive bases of accounting other than generally accepted accounting principles, known as *other comprehensive bases of accounting* (OCBOA), and establishes requirements for reporting on audits of OCBOA financial statements. Auditing Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)," of AU section 623 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .90–.98), provide additional guidance on reporting on audits of OCBOA financial statements. The AICPA Audit and Accounting Guide *State and Local Governments* discusses the application of this guidance to state and local governmental financial statements. That guide and paragraph .97 of Auditing Interpretation No. 14 also provide illustrative auditor's reports on OCBOA financial statements. In addition, in the AICPA's Practice Aid Series, two publications—*Applying OCBOA in State and Local Governmental Financial Statements* and *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*—provide nonauthoritative guidance on preparing and reporting on OCBOA financial statements.

how an entity considers and implements internal control. After obtaining an understanding of each of the components, the auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, material misstatements in relevant assertions related to classes of transactions, account balances, or disclosure, rather than its classification into a particular component. In audits of financial statements conducted in accordance with *Government Auditing Standards*, this understanding incorporates knowledge about the design of controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, as well as knowledge about whether they have been placed in operation.

Understanding Internal Control

3.08 The auditor should obtain an understanding of the five components of internal control (listed in paragraph 3.07) sufficient to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. The auditor should use the understanding of internal control to

- identify types of potential misstatements.
- consider factors that affect the risks of material misstatement.
- design tests of controls, when applicable, and substantive procedures.

The difference between obtaining an understanding of controls and testing the operating effectiveness of controls is important to note. The objective of obtaining an understanding of control is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement. (Appendix I section A.04 of *Government Auditing Standards* contains examples of internal control deficiencies.)

Documentation Requirements

3.09 Paragraph .122 of AU section 314 states that the auditor should document a number of items related to its understanding of the entity's environment, internal control and risk assessment. Among the matters that should be documented are the key elements of the understanding obtained regarding each of the aspects of the entity and its environment (as identified in paragraph 3.03), including each of the components of internal control identified (see paragraph 3.07), to assess the risks of material misstatement of the financial statements, the sources of information from which the understanding was obtained and the risk assessment procedures. The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as by the nature of the auditee's internal control. (Chapter 2 of this guide discusses the guidance regarding audit documentation as found in AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1) and *Government Auditing Standards*. See also AU section 314 for more detail on the documentation related to its understanding of the entity's environment, internal control and risk assessment.)

Communication Requirements

3.10 AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements.⁵ There are few differences between the requirements of AU section 325A and *Government Auditing Standards* relating to the communication of internal control related matters identified during an audit. (See paragraph 3.11 for additional *Government Auditing Standards* requirements.) Written communication and the use of the terminology found in AU section 325A (control deficiency, significant deficiency, and material weakness) for items that need to be identified are found in both GAAS and *Government Auditing Standards*. See chapter 4 of this guide for further discussion of the *Government Auditing Standards* requirement that the internal control communication be included in a written report. (See also paragraph 3.12.) Chapter 4 further discusses the reporting and communication requirements related to internal control over financial reporting and also provides illustrative auditor's reports. AU section 325A also provides information on identifying, evaluating, and reporting on matters that relate to an entity's internal control over financial reporting identified during an audit of financial statements.

Additional Government Auditing Standards Requirements

3.11 As discussed in chapter 2 of this guide, *Government Auditing Standards* provides certain additional fieldwork standards that may specifically affect the auditor's consideration of internal control over financial reporting as follows:

- *Government Auditing Standards* paragraph 4.06 broadens the parties included in the communication made during the planning of the audit and adds items to be communicated. *Government Auditing Standards* states that the auditor should communicate information regarding the nature of the planned work and the level of assurance to be provided related to internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. Also, any potential restrictions on the auditor's report should be communicated. These items should be communicated to management, those charged with governance, and the individuals contracting for or requesting the audit.
- *Government Auditing Standards* paragraph 4.09 states that auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements. This information should be used in assessing risk and determining the nature, timing and extent of

⁵ The GAO has issued guidance on the Yellow Book Web site at www.gao.gov/govaud.ybk01.htm that recognizes that the use of PCAOB's framework for assessing control deficiencies could result in inconsistencies in reporting internal control deficiencies under the Yellow Book. The GAO guidance facilitates the reporting of internal control deficiencies identified during audits conducted under both PCAOB and Yellow Book standards, to ensure the consistency of information included in the Yellow Book report on internal control, and to assist auditors in complying with Yellow Book standards. (See also footnote 6 at paragraph 2.07.)

current audit work, including the extent to which testing the implementation of the corrective actions is applicable to the current audit objectives.

3.12 *Government Auditing Standards* states that when providing an opinion or a disclaimer on financial statements, auditors must also report on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements. Paragraph 5.08 of *Government Auditing Standards* states that auditors should include either in the same or in separate report(s) a description of the scope of the auditor's testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. If separate reports are issued, the auditor should include reference to the separate report in the report on financial statements. Auditors should state in the report whether the tests performed provided sufficient, appropriate evidence to support the opinion on the effectiveness of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements.⁶

As discussed in chapter 4, this guide recommends a separate report on internal control over financial reporting and on compliance and other matters, which is referred to in this guide as the "Report on Internal Control over Financial Reporting and on Compliance and Other Matters."

Consideration of Financial Statement Misstatements, Including Compliance

3.13 The following paragraphs summarize the requirements of GAAS that are applicable to the auditor's consideration of financial statement misstatements, including misstatements relating to compliance,⁷ in a financial statement audit. They also discuss the additional requirements of *Government Auditing Standards*. There are unique environmental characteristics relating to compliance requirements of certain entities that are subject to audits in accordance with *Government Auditing Standards*. Federal, state, and local governments and not-for-profit organizations (NPOs) differ from commercial enterprises in that they may be subject to numerous, diverse compliance requirements. Other entities that are subject to *Government Auditing Standards* also may have transactions and balances that involve such compliance requirements. Management is responsible for ensuring compliance with relevant laws and regulations. That responsibility encompasses the identification of applicable laws and regulations and the establishment of internal control designed to provide reasonable assurance that the auditee complies with those laws and regulations.

GAAS Requirements

General Guidance

3.14 As discussed in chapters 1, "Introduction," and 2, "Planning Considerations of Government Auditing Standards" of this guide, AU section 801,

⁶ *Government Auditing Standards* permits but does not require an opinion on internal control over financial reporting if sufficient work was performed.

⁷ This guide sometimes collectively refers to laws, regulations, and provisions of contracts and grant agreements as *compliance requirements* and to illegal acts and violations of provisions of contracts or grant agreements as *noncompliance* or *instances of noncompliance*.

Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance (AICPA, *Professional Standards*, vol. 1), provides general guidance when the auditor is engaged to conduct an audit in accordance with *Government Auditing Standards*. AU section 801 describes the auditor's additional responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit when performing the audit under *Government Auditing Standards*. The guidance also instructs the auditor to apply the provisions of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol.1), relative to detecting misstatements related to illegal acts.

3.15 The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements, whether caused by error or fraud.⁸ AU section 317 describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), and AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors. The rest of this section describes the requirements of AU sections 317, 316, and 312.

Requirements Concerning Compliance

3.16 AU section 317 states that the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from illegal acts (that is, violations of laws and regulations) that have a direct and material effect on the determination of financial statement amounts. This involves identifying laws and regulations that 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. The auditor considers such laws or regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality per se.

3.17 It generally has been interpreted under GAAS that the term *laws and regulations* in AU section 317 implicitly includes provisions of contracts or grant agreements. This guide sometimes collectively refers to laws, regulations, and provisions of contracts and grant agreements as *compliance requirements* and to illegal acts and violations of provisions of contracts and grant agreements as *noncompliance* or *instances of noncompliance*.

3.18 In considering whether the financial statements may be materially misstated because of instances of noncompliance, the auditor should

- assess whether management has identified compliance requirements that have a direct and material effect on the determination of amounts in the financial statements.

⁸ Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units, the auditor's consideration of financial statement misstatements due to violations of laws and regulations (including violations of provisions of contracts and grant agreements, fraud, or error in planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements should address each opinion unit. See that guide for further guidance.

- obtain an understanding of the possible effects of these compliance requirements on the determination of financial statement amounts.
- assess the risk that a material misstatement of the financial statements has occurred because of instances of noncompliance.
- design and conduct the audit to provide reasonable assurance of detecting such material noncompliance.

3.19 The auditor may consider performing the following procedures in assessing management's identification of these compliance requirements and in obtaining an understanding of their possible effects on the determination of financial statement amounts:

- a. Consider knowledge about these compliance requirements that has been obtained from prior years' audits.
- b. Discuss these compliance requirements with the auditee's chief financial officer, legal counsel, or grant administrators.
- c. Obtain written representation from management regarding the completeness of management's identification of compliance requirements (see paragraph 3.37).
- d. Review the relevant portions of any directly related agreements, such as those related to grants and debt agreements.
- e. Identify sources of revenue, review any related agreements (for example, debt agreements or grant agreements), and inquire about the applicability of any overall governmental regulations to the accounting for the revenue.
- f. Obtain publications pertaining to compliance requirements. Such publications include those that address federal tax and other reporting requirements, such as the Department of the Treasury and the Internal Revenue Service requirements pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.
- g. Obtain copies of, and review pertinent sections of, laws and regulations—including federal and state constitutions, articles of incorporation, charters, and bylaws—concerning the auditee. The sections of these documents pertaining, as applicable, to financial reporting, investments, debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- h. Review the minutes of meetings of the governing body of the auditee for the enactment of laws and regulations or information about contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- i. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about the compliance requirements applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- j. Review information about applicable federal and state program compliance requirements, such as the information included in the *Office of Management and Budget (OMB) Circular A-133 Compliance Supplement (Compliance Supplement)*, the *Catalog of Federal Domestic Assistance*, federal audit guides, and state and local policies and procedures.

- k. Review the guidance contained in the applicable AICPA Audit and Accounting Guides and the materials available from other professional organizations, such as state societies of CPAs or industry associations.
- l. Inquire of the audit, finance, or program administrators from which the auditee receives grants about the restrictions, limitations, terms, and conditions under which such grants were provided. Those administrators usually can be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.

3.20 In obtaining an understanding of the possible effects on financial statements of compliance requirements that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts, the auditor might consider

- the materiality of the effect on financial statement amounts, in both quantitative and qualitative terms.
- the likelihood that noncompliance may occur.
- the level of management or employee involvement in the compliance-assurance process.
- the opportunity for concealment of instances of noncompliance.

3.21 To summarize, as part of assessing the risks of material misstatement, the auditor should assess the risk that instances of noncompliance may cause such a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting instances of noncompliance that are material to the financial statements. Therefore, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from instances of noncompliance that have a direct and material effect on the determination of financial statement amounts.

3.22 Auditees may be affected by many other laws and regulations, including those related to occupational safety and health, environmental protection, equal employment, food and drug administration, and price fixing or other antitrust violations. Those laws and regulations generally concern an auditee's operations more than financial reporting and accounting. Their effect on an auditee's financial statements is indirect and normally takes the form of the disclosure of a contingent liability that follows from the allegation or determination of illegality. The auditor ordinarily would not have a sufficient basis to recognize possible violations of these laws and regulations. Even when violations of such laws and regulations can have consequences that are material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the auditee, or unless there is evidence of an investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.⁹

⁹ In addition, for compliance with laws and regulations that have an indirect effect on the determination of financial statement amounts, AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), notes that, where applicable, the auditor should inquire of management concerning (a) the auditee's policies relative to the prevention of illegal acts and (b) the use of directives issued by the auditee and periodic representations obtained by the auditee from management at appropriate levels of authority, concerning compliance with laws and regulations.

3.23 If specific information comes to the auditor's attention that provides evidence concerning the existence of possible instances of noncompliance that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an instance of noncompliance occurred. However, because of the characteristics of such noncompliance, an audit conducted in accordance with GAAS provides no assurance that indirect-effect instances of noncompliance will be detected or that any contingent liabilities that may result will be disclosed.

AU section 316 Requirements Concerning Fraud

3.24 AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1), states that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. AU section 316 provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS. A unique aspect of the guidance related to fraud is that whenever the auditor has determined that there is evidence that fraud exists, that matter should be brought to the attention of an appropriate level of management, even if the matter is considered inconsequential.

3.25 Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that result in a material misstatement of the financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of financial statements is intentional or unintentional. Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets. Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act. Paragraphs .05–.12 of AU section 316 further discuss the two types of misstatements, the three conditions, as well as other characteristics of fraud.

3.26 The risk of material misstatement of the financial statements due to fraud is part of audit risk. AU section 316 states that, as part of planning the audit, there should be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. The auditor also should specifically:¹⁰

¹⁰ When the auditor is considering risk factors and other information that may be helpful in identifying risks of material misstatement due to fraud in an audit of financial statements of an entity that receives federal awards, the auditor's responsibilities under AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), include the consideration of risk factors associated with the receipt of federal awards that could present a material misstatement of the financial statements. This is especially true in audits conducted in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133).

- Obtain the information needed to identify the risks of material misstatement due to fraud, which includes making inquiries of management and others within the entity, considering the results of analytical procedures performed in planning, and considering fraud risk factors and other information that might be helpful in identifying risks (see paragraphs .19–.34 of AU section 316).
- Identify the risks that may result in a material misstatement due to fraud by considering the information gathered in the previous bullet and the risk of management override of controls (paragraphs .35–.42 of AU section 316).
- Assess the identified risks after taking into account an evaluation of the entity's programs and controls that address the risks (paragraphs .43–.45 of AU section 316).
- Respond to the assessments of the risks of material misstatement due to fraud by, among other things, modifying the nature, timing, and extent of auditing procedures to address the identified risks (paragraphs .46–.56 of AU section 316).
- Address the risk of management override of controls by performing procedures that include examining journal entries and other adjustments, reviewing accounting estimates for biases, and evaluating the business rationale for significant unusual transactions (paragraphs .57–.67 of AU section 316).

Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. In addition, the auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit.

3.27 Auditors may wish to refer to the AICPA Practice Aid titled *Fraud Detection in a GAAS Audit: Revised Edition*, which includes specific guidance on applying the concepts of AU section 316 to several industries, including government, health care organizations, NPOs, and real estate entities, and to recipients of federal awards. Among other things, it identifies example risk factors for those industries and recipients. In addition, appendix I section A.07 and A.08 of *Government Auditing Standards* contains information related to indicators of fraud risk. Auditors should also refer to the applicable AICPA Audit and Accounting Guides, such as *Health Care Organizations, Not-for-Profit Organizations*, and *State and Local Governments* for additional industry-specific guidance on fulfilling the requirements of AU section 316.

3.28 Paragraph .83 of AU section 316 provides a list of the items and events that the auditor should document regarding their consideration of fraud. Among other things, the auditor should document the discussion among engagement personnel in planning the audit regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud, the specific risks of material misstatement due to fraud that were identified, and a description of the auditor's response to those risks.

3.29 AU section 316 also addresses the evaluation of audit evidence and communications about possible fraud to management, those charged with governance, and others. Refer to paragraphs .68–.82 of AU section 316 for more information. Chapter 4 of this guide discusses the auditor's responsibilities under AU section 316 for communications about fraud.

Requirements Concerning Errors

3.30 AU section 312 provides guidance to auditors in fulfilling the responsibility described in paragraph 3.24, as it relates to errors, in an audit of financial statements conducted in accordance with GAAS. Errors are described as unintentional misstatements, or as omissions of amounts or disclosures, in financial statements. Errors may involve (a) mistakes in gathering or processing data from which financial statements are prepared, (b) unreasonable accounting estimates arising from oversight or the misinterpretation of facts, and (c) mistakes in the application of accounting principles relating to amounts, classification, the manner of presentation, or disclosure. When the auditor is considering his or her responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, there is no important distinction between error and fraud. There is a distinction, however, in the auditor's response to detected misstatements. An isolated, immaterial error in processing accounting data or in applying accounting principles generally is not significant to the audit. In contrast, when the auditor encounters evidence of potential fraud, regardless of its materiality, the auditor should consider its implications for the integrity of management or employees and its possible effect on other aspects of the audit. (See AU section 312 for more detailed guidance.)

Audit Documentation

3.31 The auditor should document the procedures performed to evaluate compliance with laws and regulations (including violations of provisions of contracts and grant agreements—see paragraph 3.17 and related footnote 7 at paragraph 3.13) that have a direct and material effect on the determination of financial statement amounts in accordance with AU section 339. As discussed in paragraph 3.28, AU section 316 provides requirements and guidance on the documentation of certain items and events related to the auditor's consideration of fraud. As discussed in paragraph 3.09, AU section 314 provides requirements and guidance related to documentation of the auditor's understanding of internal control over financial reporting, including as it pertains to compliance, and the related assessment of control risk. AU section 312 states that the auditor should document a summary of uncorrected misstatements, other than those that are trivial, related to both known and likely misstatements. Also, the auditor should document his or her conclusion as to whether the uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion. See paragraphs .69–.70 of AU section 312 for other documentation guidance related to misstatements. (Chapter 2 of this guide discusses the guidance regarding audit documentation as found in AU section 339 and *Government Auditing Standards*.)

Additional Government Auditing Standards Requirements

3.32 *Government Auditing Standards* provides certain additional fieldwork standards that may specifically affect the auditor's consideration of compliance and fraud as follows:¹¹

- *Government Auditing Standards* paragraph 4.05 discusses what the auditor should communicate regarding the nature, timing, and

¹¹ See also chapter 2 of this guide for a general discussion of fieldwork standards under *Government Auditing Standards*.

extent of planned testing and reporting and the level of assurance on compliance with laws, regulations, and provisions of contracts or grant agreements to those charged with governance during the planning stages of an audit. This standard is based on AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), but broadens the parties included in the communication and the items to be communicated. (See paragraphs 2.28–.29 for a discussion of additional items to be communicated and parties to be included in the communication.)

- *Government Auditing Standards* paragraph 4.10 specifically states that the auditor should design the audit to provide reasonable assurance of detecting misstatements resulting from non-compliance with provisions of contracts or grant agreements that could have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives. Guidance regarding the auditor's responsibility when abuse or potential abuse is discovered can be found in paragraph 3.34.
- *Government Auditing Standards* paragraph 4.09 discusses the auditor's responsibility to evaluate management's level of corrective action of findings and recommendations from previous audits, attestation engagements, and other studies on the risk assessment procedures used to plan the current audit.

3.33 *Government Auditing Standards* also provides certain additional reporting standards related to compliance and fraud, including:

- a. As discussed in paragraph 5.08 of *Government Auditing Standards*, a description of the scope of the auditor's testing of compliance with laws, regulations, and provisions of contracts or grant agreements and the results of those tests.¹² (This information is communicated in the report on internal control over financial reporting and on compliance and other matters.)
- b. As discussed in paragraph 5.15 of *Government Auditing Standards*, instances of fraud and illegal acts that have an effect on the financial statements that is more than inconsequential,¹³ and violations of provisions of contracts or grant agreements that have a material effect on the determination of financial statement amounts or other financial data significant to the audit. (This information is communicated in the report on internal control over financial reporting and on compliance and other matters.)
- c. As discussed in paragraph 5.16 of *Government Auditing Standards*, violations of provisions of contracts or grant agreements or abuse

¹² *Government Auditing Standards* permits but does not require an opinion on compliance if sufficient work was performed.

¹³ In an audit in accordance with Circular A-133, the auditor should apply a financial statement materiality consideration in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting. That is because those findings already are reported in the Circular A-133 report and reporting findings that are not material to the financial statements again in the *Government Auditing Standards* report would be unnecessarily duplicative. See chapters 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," and 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide.

detected that are less than material but more than inconsequential should be communicated in writing to officials of the audited entity.

Chapter 4 of this guide further discusses the reporting and communication requirements related to compliance and fraud. That chapter also provides illustrative auditor's reports on internal control over financial reporting and on compliance on other matters.

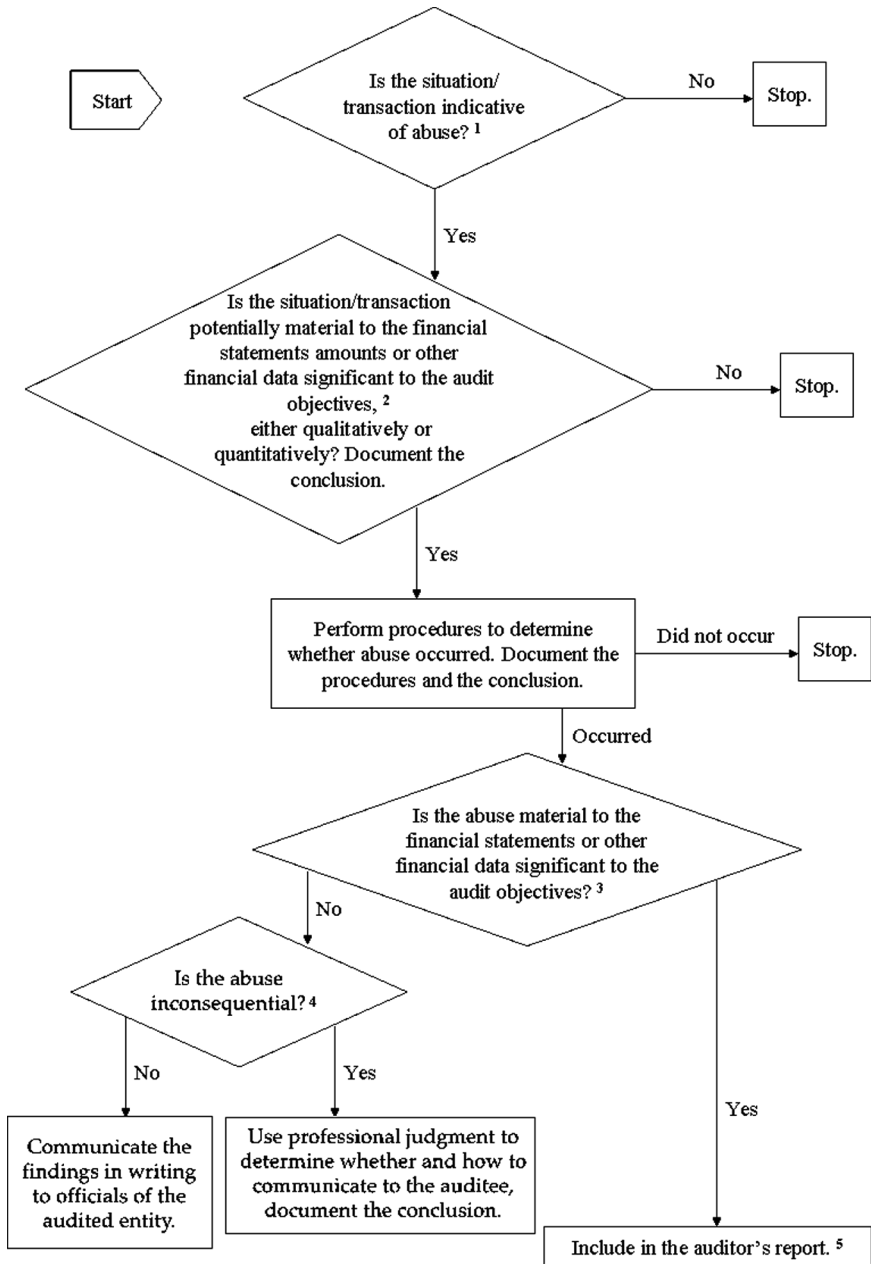
Consideration of Abuse

3.34 Paragraphs 4.12–.13 of *Government Auditing Standards* contain an additional fieldwork standard relating to the auditor's responsibility concerning abuse. Auditors have no responsibility to design the audit to detect abuse under either GAAS or *Government Auditing Standards*. However, under *Government Auditing Standards*, if auditors become aware of indications of abuse that could be quantitatively or qualitatively material to the financial statements, they should apply audit procedures specifically directed to ascertain the potential effect on the financial statements or other financial data significant to the audit objectives.¹⁴ Paragraph 4.12 of *Government Auditing Standards* describes "abuse" by stating that it does not necessarily involve fraud, illegal acts, and violations of provisions of contracts or grant agreements. Abuse, it states, "involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances." Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. Appendix I section A.06 of *Government Auditing Standards* contains examples of possible abuse. Exhibit 3-1 is a flowchart that illustrates the evaluation and reporting of possible abuse. Chapter 4 of this guide discusses the reporting standard for abuse and provides illustrative auditor's reports on internal control over financial reporting and on compliance on other matters.

¹⁴ The reference in *Government Auditing Standards* to "other financial data significant to the audit objectives" relates to auditing procedures on financial data outside of the basic financial statements. For example, it may relate to required supplementary information (RSI) and supplementary information other than RSI (known as SI). It also relates to financial audits other than the audits of financial statements, including compliance audits conducted in accordance with Circular A-133. See the discussion of the effect of this requirement on compliance audits conducted in accordance with Circular A-133 in chapters 9, "Consideration of Internal Control over Compliance for Major Programs," and 10, "Compliance Auditing Applicable to Major Programs," of this guide.

Exhibit 3-1

Evaluation and Reporting of Findings of Possible Abuse



-
- ¹ Auditors have no responsibility to design the audit to detect abuse. The steps in this flowchart may be used when the auditor becomes aware of indications of abuse.
 - ² Chapters 9, "Consideration of Internal Control over Compliance for Major Programs," and 10, "Compliance Auditing Applicable to Major Programs," of this guide discuss additional considerations in evaluating abuse related to federal awards in an audit conducted in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). Of note in those discussions is that situations or transactions involving federal awards that might otherwise appear to constitute abuse instead generally are instances of noncompliance.
 - ³ Chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide discusses paragraphs 5.18–20 of *Government Auditing Standards* which states that auditors should report abuse directly to parties outside of the auditee in certain circumstances.
 - ⁴ Generally, *Government Auditing Standards* instructs the auditor to evaluate findings for the purpose of communication in the management letter or other written communication based on their consequence to the financial statements or other financial data significant to the audit objectives. As discussed in chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide, however, in an audit in accordance with Circular A-133, the auditor should evaluate findings involving federal awards for the purpose of that communication based only on their consequence to the financial statements.
 - ⁵ The auditor should report material abuse findings related to financial statement audits in the report on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards*. Chapter 4 of this guide discusses when to report those abuse findings in the internal control section of that report or instead in the section on compliance and other matters. Chapter 12 of this guide discusses the reporting of abuse findings related to federal awards in a Circular A-133 audit, including that the auditor may need to report those findings in both (a) the report on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards* and (b) the report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133.
-

3.35 If an auditor becomes aware of a situation or transaction that might constitute abuse, the auditor should perform procedures (such as making inquiries of auditee officials about the nature of and reasons for the situation or transaction) to determine whether it is indicative of abuse. Those procedures involve evaluating whether the situation or transaction meets the definition of abuse or whether it also involves fraud or illegal acts. This distinction is important because *Government Auditing Standards*¹⁵ has different reporting standards for abuse as compared to fraud and illegal acts, as discussed in chapter

¹⁵ As discussed in chapters 9 and 10 of this guide, because the OMB cost principles circulars require that costs charged to federal awards be reasonable and necessary for the performance and administration of the awards, situations or transactions involving federal awards that might otherwise appear to constitute abuse instead generally are instances of noncompliance.

4 of this guide. Those procedures also involve evaluating whether the situation or transaction involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. This determination is subjective and auditor judgment is a factor. If the auditor concludes that a situation or transaction is indicative of abuse, the auditor should evaluate whether it is potentially material to the financial statement amounts¹⁶ or other financial data significant to the audit objectives. If the situation or transaction is potentially material, the auditor should perform additional procedures (such as extending sample sizes by selectively choosing items for testwork). Auditors should evaluate whether a situation or transaction that constitutes abuse is material to financial statement amounts or other financial data significant to the audit objectives based on both quantitative factors and qualitative factors. Qualitative factors that the auditor may consider relevant to that evaluation include the following:

- Whether the abuse is the result of a significant deficiency in internal control
- The potential effect of the abuse on the entity's ability to raise resources (for example, through taxes, grants, contributions, or debt or loan financings) in the future
- The potential effect of the abuse on the continuation of existing relationships with vendors, employees, and elected and appointed officials
- Whether the abuse involves collusion or concealment
- Whether the abuse involves an activity that often is scrutinized by elected or appointed officials, citizens, the press, creditors, or rating agencies
- Whether the fact of the abuse is unambiguous rather than a matter of judgment
- Whether the abuse is an isolated event or instead has occurred with some frequency
- Whether the abuse results from management's continued unwillingness to correct internal control weaknesses
- The likelihood that similar abuse will continue in the future
- The cost-benefit of establishing internal control to prevent similar abuse in the future
- The risk that possible undetected abuse would affect the auditor's evaluation

3.36 As indicated in exhibit 3-1, *Government Auditing Standards* provides guidance for reporting immaterial abuse outside of the auditor's report. Given the process for categorizing a situation or transaction as constituting abuse, and given that abuse often is material based on qualitative rather than quantitative factors, findings of abuse generally would be material or at least consequential. However, an auditor might conclude that identified abuse is inconsequential.

¹⁶ Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units, the auditor's consideration of abuse in planning, performing, evaluating the results of, and reporting on the audit of a government's basic financial statements should address each opinion unit. See that guide for further guidance.

For example, the auditor might find an isolated instance of abuse at an entity that subsequently instituted controls to prevent future, similar abuse.

Written Representations From Management

3.37 AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), states that the auditor should obtain written representations from management as part of an audit conducted in accordance with GAAS. It also includes an illustrative management representation letter and an appendix containing additional representations that may be appropriate to be included in a management representation letter in certain circumstances. With respect to a financial statement audit conducted in accordance with GAAS and *Government Auditing Standards*, representations ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry. For example, the auditors could consider obtaining additional representations from management acknowledging that management¹⁷

- a. is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the auditee.
- b. is responsible for establishing and maintaining effective internal control over financial reporting.
- c. has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.
- d. has identified and disclosed to the auditor violations (and possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements, as a basis for recording a loss contingency, or for auditor reporting on noncompliance.
- e. has reviewed, approved, and taken responsibility for the financial statements and related notes and an acknowledgment of the auditor's role in the preparation of this information. (This representation is one that should be made as noted in paragraph 3.28a of *Government Auditing Standards* when the auditor has a role in preparing the trial balance and draft financial statements and related notes.)
- f. has taken timely and appropriate steps to remedy fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that the auditor reports.
- g. has a process to track the status of audit findings and recommendations.
- h. has identified for the auditor previous financial audits, attestation engagements, performance audits, or other studies related to the objectives of the audit being undertaken and the corrective actions taken to implement the related recommendations.

¹⁷ The auditor should modify these representations, as appropriate, for different conditions, such as if management does not have a process to track the status of audit findings and recommendations.

- i. has provided views on the auditors' reported findings, conclusions, and recommendations, as well as management's planned corrective actions, for the report.

An auditor should obtain representations from those members of management with overall responsibility for financial and operating matters that the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others in equivalent positions (such as the management of component organizations). It often is desirable to obtain representation letters from other officials (for example, asking the recording secretary for the governing body to represent that the minutes are complete for all meetings held during the period and through the date of the auditor's report). The written representations should be dated as of the date of the auditor's report. This is to ensure that the auditor's report is not dated prior to the date on which the auditor has obtained sufficient appropriate audit evidence (Paragraph .23 of AU section 339).

Reasonable Assurance

3.38 AU section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1), states that the high, but not absolute, level of assurance that is intended to be obtained by the auditor is expressed in the auditors report as obtaining reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Therefore, an audit conducted in accordance with GAAS may not detect a material misstatement. It also states that because the auditor's opinion on the financial statements is based on the concept of obtaining 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, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with GAAS. Paragraph 3.39 of *Government Auditing Standards* similarly states in part that "while this standard places responsibility on each auditor and audit organization to exercise professional judgment in planning and performing an audit or attestation engagement, it does not imply unlimited responsibility, nor does it imply infallibility on the part of either the individual auditor or the audit organization." Further, paragraph 4.13 of *Government Auditing Standards* states that the determination of abuse is subjective and that auditors are not required to provide reasonable assurance of detecting abuse.

Chapter 4

Auditor Reporting Requirements and Other Communication Considerations of Government Auditing Standards

Note: *Government Auditing Standards* is periodically amended and codified. This guide includes guidance from the most recent revision of *Government Auditing Standards* issued July 2007, which was effective for financial audits, including financial statement audits, for periods beginning on or after January 1, 2008. Auditors who are performing audits conducted under the previous version of *Government Auditing Standards*, issued in 2003, can refer to the prior edition of this guide dated May 1, 2007, for the applicable guidance.

Overview

4.01 This chapter discusses the auditor's reporting requirements and other communication considerations in an audit of financial statements conducted in accordance with *Government Auditing Standards*. (Appendix A [paragraph 4.51] presents illustrative auditor's reports for those audits.) Primary among the reporting requirements are that the auditor (a) express an opinion or disclaim an opinion on the financial statements¹ and (b) report on internal control over financial reporting and on compliance and other matters.

Government Auditing Standards—Reporting Requirements

Generally Accepted Auditing Standards Requirements

4.02 Generally accepted auditing standards (GAAS) contain 4 reporting standards, all of which are incorporated into *Government Auditing Standards*.² The 4 standards, as found in paragraph .02 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol.1) (See also paragraph 5.03 of *Government Auditing Standards*) follow:

¹ As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government's basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. In addition, the auditor may provide opinions or disclaimers of opinions on additional opinion units if engaged to set the scope of the audit and assess materiality at a more detailed level than by the opinion units required for the basic financial statements. Throughout this guide, the use of the singular terms *opinion* and *disclaimer of opinion* encompasses the multiple opinions and disclaimers of opinion that generally will be provided on a government's financial statements.

² *Government Auditing Standards* incorporates the fieldwork and reporting standards of generally accepted auditing standards (GAAS) and the related Statements on Auditing Standards (SASs) issued by the AICPA unless the Comptroller General of the United States excludes them by formal announcement. To date, the Comptroller General has not excluded any fieldwork or reporting standards or related SASs.

- The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
- The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
- When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.
- The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefore in the auditor's report. In all cases in which an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking in the auditor's report.

4.03 AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), establishes requirements for reporting on audits of financial statements that are intended to be presented in conformity with GAAP. AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), establishes requirements for reporting on audits of financial statements that are prepared in conformity with a comprehensive basis of accounting other than GAAP, known as *other comprehensive bases of accounting*, or OCBOA.³ AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1); AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1); and AU section 558, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1), provide guidance on reporting on additional information that accompanies the basic financial statements—both required supplementary information (RSI) and supplementary information other than RSI, known as SI.⁴ Auditors also should refer to applicable AICPA Audit and Accounting Guides, such as *Health Care Organizations*, *Not-For-Profit Organizations*, and *State and Local Governments*, for additional guidance on reporting on the financial statements of specific industries.

³ Interpretations No. 14 "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" and No. 15 "Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request" of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .90–.98), provide additional guidance on reporting on audits of financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), known as *other comprehensive bases of accounting*, or OCBOA. The AICPA Audit and Accounting Guide *State and Local Governments* discusses the application of AU section 623 and Interpretation Nos. 14–15 of AU section 623 to state and local governmental financial statements. That guide and paragraph .97 of Interpretation No. 15 also provide illustrative auditor's reports on OCBOA financial statements. In addition, in the AICPA's Practice Aid Series, two publications—*Applying OCBOA in State and Local Governmental Financial Statements* and *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*—provide nonauthoritative guidance on preparing and reporting on financial statements prepared in conformity with OCBOA.

⁴ The Audit and Accounting Guide *State and Local Governments* includes flowcharts that summarize auditor procedures and reporting on required supplementary information (RSI) and supplementary information other than RSI, known as SI.

Government Auditing Standards—Additional Reporting Standards

4.04 *Government Auditing Standards* requires that in addition to providing an opinion or a disclaimer of opinion on the financial statements, the auditor must report on internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements.⁵ The auditor also should report certain fraud and abuse.

4.05 *Government Auditing Standards* contains the following 8 reporting standards in addition to the AICPA standards listed in paragraph 4.02:

- a. When the report on the financial statements is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, or when those standards are voluntarily followed, the report should state that the audit was performed in accordance with generally accepted government auditing standards. When citing compliance with *Government Auditing Standards*, the auditor should include either an unmodified compliance statement or a modified compliance statement, as appropriate. (See paragraphs 5.05–.06 of *Government Auditing Standards*.) Paragraphs 4.24–.25 discuss this requirement.
- b. When providing an opinion or a disclaimer on financial statements, auditors must also report on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements. In the same or in separate report(s), the auditors should include a description of the scope of the auditor's testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. Auditors should state in the report whether the tests performed provided sufficient, appropriate evidence to support an opinion of the effectiveness of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements. (See paragraph 5.08 of *Government Auditing Standards*.)⁶ When auditors report separately (including separate reports bound in the same document) on internal control over financial reporting and on compliance with laws and regulations and provisions of contracts or grant agreements, they should state in the financial statement audit report that they are issuing those additional reports. Auditors should also state that the reports on internal control over financial reporting and on compliance with laws and regulations and provisions of grant agreements are an integral part of a *Government Auditing Standards* audit and important for assessing the results of the audit. This guide recommends a separate report on internal control over financial

⁵ *Government Auditing Standards* and AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), define the term *illegal acts* as violations of laws and regulations. As indicated in chapter 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide, it generally has been interpreted under GAAS that the term *laws and regulations* in AU section 317 implicitly includes provisions of contracts or grant agreements. This guide sometimes collectively refers to laws, regulations, and provisions of contracts and grant agreements as *compliance requirements* and to illegal acts and violations of provisions of contracts or grant agreements as *noncompliance* or *instances of noncompliance*.

⁶ Paragraph 5.08 of *Government Auditing Standards* permits, but does not require, an opinion on internal control over financial reporting or on compliance if sufficient work was performed.

reporting and on compliance and other matters, which is referred to in this guide as the "Report on Internal Control over Financial Reporting and on Compliance and Other Matters." This guide also recommends that the reference to the separate report indicate that the separate report does not provide an opinion on internal control over financial reporting or on compliance.⁷ See the illustrative reports in appendix A (paragraph 4.51), examples 4-3 and 4-5. Paragraphs 4.08–.10, 4.27, and 4.28 further discuss reporting on internal control over financial reporting and on compliance.

- c. For financial audits, including audits of financial statements in which auditors provide an opinion or disclaimer, auditors should report, as applicable to the objectives of the audit and based upon the audit work performed, (1) significant deficiencies in internal control,⁸ identifying those considered to be material weaknesses, (2) all instances of fraud and illegal acts unless inconsequential, and (3) violations of provisions of contracts or grant agreements and abuse that could have a material effect on the financial statements.⁹ In some circumstances, auditors should report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to parties external to the audited entity. (See paragraph 5.18 of *Government Auditing Standards*.) Paragraphs 4.09, 4.16–.17, and 4.27–.28 further discuss the requirements of this standard, and paragraphs 4.29–.34 discuss the reporting of findings.
- d. Under AICPA standards, an auditor may emphasize in the auditor's report certain significant matters regarding the financial statements as found in paragraph .19 of AU section 508. *Government Auditing Standards* expands the matters that may be included in the report. Determining whether to include such information in the auditor's report is a matter of professional judgment. The communication may be put in a separate paragraph or separate section of the auditor's report and may include information that is not disclosed in the financial statements. Paragraph 5.24 of *Government Auditing Standards* discusses examples of items that may be communicated. The 4 matters listed are (1) significant concerns or uncertainties about the fiscal sustainability of a government or program or other matters that could have a significant impact on the financial condition or operation of the government entity beyond

⁷ This guide makes this recommendation so that report users who are accustomed to an opinion on internal control over financial reporting in auditor's reports for "issuers," as that term is defined by the Sarbanes-Oxley Act of 2002 or whose audit is prescribed by the rules of the Securities and Exchange Commission (SEC), do not assume that the separate report provides opinions on internal control over financial reporting or compliance. If the auditor provides an opinion on internal control over financial reporting or on compliance (see footnote 6 in paragraph 4.05b), the reference to the separate report should indicate that there is such an opinion.

⁸ Paragraph 5.13 of *Government Auditing Standards* states that if (1) a significant deficiency is remediated before the auditors' report is issued and (2) the auditors obtain sufficient, appropriate evidence supporting the remediation of the significant deficiency, then the auditors should report the significant deficiency and the fact that it was remediated before the auditors' report was issued.

⁹ *Government Auditing Standards* requires this reporting even if the auditor disclaims an opinion on the financial statements. These findings are communicated in the report on internal control over financial reporting and on compliance and other matters. *Government Auditing Standards* also provides reporting requirements for other findings of internal control deficiencies, fraud, illegal acts, violations of provisions of contracts or grants agreements, and abuse, as summarized in table 4-1 and discussed in paragraph 4.37.

1 year of the financial statement date (although the auditor is not responsible for designing audit procedures to detect such concerns or uncertainties, and any judgment about the future is based on information that is available at the time the judgment is made); (2) unusual or catastrophic events that will likely have a significant ongoing or future impact on the entity operations or its financial condition; (3) significant uncertainties surrounding projections or estimates in the financial statements; and (4) any other matter that the auditors consider significant for communication to users and oversight bodies.

- e. When auditors become aware of new information that could have affected their report on previously issued financial statements, paragraphs 5.26–.31 of *Government Auditing Standards* provide requirements that go beyond the AICPA requirements found in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1). In addition to AICPA requirements, *Government Auditing Standards* state that auditors should advise management to make appropriate disclosures when it is likely that previously issued financial statements are misstated and the misstatement is, or reasonably could be, material. The auditors should also perform certain procedures related to the restated financial statements as described in *Government Auditing Standards* paragraph 5.27. The auditor should evaluate the timeliness and appropriateness of management's disclosure and actions to determine and correct misstatements in previously-issued financial statements, update the auditor's report on restated financial statements, and report directly to appropriate officials when the audited entity does not take the necessary steps.
- f. If the auditors' report discloses deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse, auditors should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions. (See paragraphs 5.32–.38 of *Government Auditing Standards*). Paragraphs 4.35–.36 further discuss the requirements of this standard.
- g. If certain pertinent information is prohibited from public disclosure (as it may be by federal, state, or local laws or regulations) or is excluded from a report due to the confidential or sensitive nature of the information, auditors should disclose in the report that certain information has been omitted and the reason or other circumstances that make the omission necessary. (See paragraphs 5.39–.43 of *Government Auditing Standards*, which also discuss the issuance and distribution of separate classified or limited use reports containing omitted information, including information that is omitted because of public safety and security concerns.)
- h. Audit organizations in government entities should distribute audit reports to those charged with governance, the appropriate officials of the audited entity, and to appropriate oversight bodies or organizations requiring or arranging for the audits. As appropriate, they should also distribute copies of the reports to other officials who have legal oversight authority or who may be responsible for acting

on audit findings and recommendations and to others authorized to receive such reports. Public accounting firms contracted to perform an audit under *Government Auditing Standards* should clarify report distribution responsibilities with the engaging organization.¹⁰ If the contracted firm is to make the distribution, it should reach agreement with the party contracting for the audit about which officials or organizations will receive the report and the steps being taken to make the report available to the public. (See paragraph 5.44 of *Government Auditing Standards*.)

4.06 Table 4-1 summarizes *Government Auditing Standards* requirements for reporting matters relating to internal control over financial reporting, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse, as discussed in this chapter.

¹⁰ This guide recommends that auditors make the required clarification in the engagement letter or other understanding with the auditee; see chapter 2, "Planning Considerations of *Government Auditing Standards*," of this guide. In addition, auditors could make the clarification in correspondence that transmits the reports to the auditee and other recipients.

Table 4-1

**Government Auditing Standards
Requirements for Reporting Findings**

| | <i>Report on Internal Control Over Financial Reporting and on Compliance and Other Matters</i> | <i>Communicate in Writing¹</i> | <i>Auditors Use Professional Judgment to Determine Reporting</i> |
|-------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------|-----------------------------------------------|----------------------------------------------------------------------------------|
| Deficiencies in internal control over financial reporting: | | | |
| Significant deficiencies (Those that are, either individually or in the aggregate, material weaknesses should be so identified.) | X | | |
| Other control deficiencies that are not significant deficiencies or material weaknesses | | | X |
| Fraud and illegal acts: | | | |
| Those that have an effect on the financial statements that is more than inconsequential ² | X | | |
| Those that are inconsequential | | | X |
| Violations of provisions of contracts or grant agreements and abuse: | | | |
| Those that have a material effect on the financial statements or other data significant to the audit | X | | |
| Less than material but more than inconsequential | | X | |
| Those that are inconsequential | | | X |

(continued)

¹ See paragraph 4.37 and footnote 35.

² As explained in paragraph 4.16, in an audit in accordance with Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the auditor should apply a financial statement materiality consideration in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting.

Internal Control Over Financial Reporting¹¹

GAAS Requirements

4.07 AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on communicating matters related to an auditee's internal control over financial reporting identified in an audit of financial statements. AU section 325A states that the auditor must communicate, in writing, significant deficiencies and material weaknesses identified in the audit to management and those charged with governance. Those charged with governance are the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to accountability of the entity, including overseeing financial reporting and disclosures, such as the board of directors, the board of trustees, or an owner in an owner-managed enterprise. Other examples include governing boards, city councils, audit committees, mayors, governors, legislators, university/college presidents, and chancellors. Significant deficiencies and material weaknesses that were previously communicated and have not yet been remediated may be communicated in writing by referring to the previously issued written communication and the date of that communication. In addition to requiring the communication of significant deficiencies and material weaknesses in the internal control over financial reporting, AU section 325A states that because timely communication may be important, the auditor may choose to communicate significant matters related to the internal control over financial reporting orally during the course of the audit rather than waiting until after the audit is concluded. However, even in that case, the communication of any significant deficiencies and material weaknesses must also be in writing. While AU section 325A states that the written communication should be made no later than 60 days following the report release date, it also states that the communication is best made by the report release date. When performing an audit in accordance with *Government Auditing Standards*, the issuance of the required internal control reporting described in paragraphs 4.08–.09 and 4.27–.28 meets the AU section 325A communication requirements. A separate communication to meet AU section 325A requirements is not necessary when the auditor is issuing a *Government Auditing Standards* report, "Report on

¹¹ Chapter 3 of this guide discusses the auditor's consideration of internal control over financial reporting. Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units (see footnote 1 in paragraph 4.01), the auditor's consideration of internal control over financial reporting in planning, performing, evaluating the results of, and reporting on the audit should address each opinion unit.

Internal Control over Financial Reporting and on Compliance and Other Matters," that describes the scope of the auditor's testing of internal control over financial reporting and presents the results of those tests.

Government Auditing Standards Requirements

4.08 As discussed in paragraph 4.05*b*, paragraph 5.07 of *Government Auditing Standards* states that the auditor must issue a report on internal control over financial reporting. That report should describe the scope of the auditor's testing of internal control over financial reporting and whether the tests performed provided sufficient, appropriate audit evidence to support an opinion on the effectiveness of internal control over financial reporting. Written reporting on internal control matters under *Government Auditing Standards* is based on the auditor's consideration of the internal control over financial reporting as required by AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1). See chapter 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide. The report should describe the extent of the work performed under the provisions of AU section 314 and encompass the requirements of AU section 325A as well as the additional requirements of *Government Auditing Standards*. While not required, *Government Auditing Standards* does permit the report to express an opinion on the auditee's internal control over financial reporting if sufficient work was performed.

4.09 Paragraph 5.10 of *Government Auditing Standards* states that auditors should report significant deficiencies and material weaknesses in internal control over financial reporting as defined in paragraph 5.11 of *Government Auditing Standards*.¹² Appendix I paragraph A.04 of *Government Auditing Standards* contain, examples of control deficiencies, and AU section 325A also provides guidance on evaluating potential control deficiencies and examples of circumstances that may be control deficiencies, significant deficiencies, and material weaknesses. Paragraphs 4.29–.34 of this chapter describe *Government Auditing Standards* requirements for presenting audit findings, including deficiencies in internal control. Paragraph .29 of AU section 325A prohibits the auditor from issuing a written report representing that no significant deficiencies were identified during an audit. The illustrative report in appendix A (paragraph 4.51), example 4-3, provides recommended language that satisfies the requirements of *Government Auditing Standards* when no significant deficiencies were identified during an audit. The illustrative report in appendix A (paragraph 4.51), example 4-5, provides recommended language that satisfies the requirements of *Government Auditing Standards* when significant deficiencies (whether or not they are considered to be material weaknesses) are noted during an audit.

4.10 Table 4-2 summarizes the differences between AU section 325A and *Government Auditing Standards* with respect to reporting on internal control over financial reporting.

¹² The definitions of *significant deficiency* and *material weakness* in paragraph 5.11 of *Government Auditing Standards* are consistent with those found in AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1).

Table 4-2

Reporting on Internal Control Over Financial Reporting

| | Government Auditing Standards | <i>AU section 325</i> |
|--------------------------------------------------------------------|----------------------------------------------------------|---------------------------------------------------------------------|
| How are significant deficiencies and material weaknesses reported? | In a report on internal control over financial reporting | In a communication to management and those charged with governance |
| When is reporting required? | For every financial statement audit | When significant deficiencies or material weaknesses are identified |
| What is the form of the report? | Written | Written |

Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, and Abuse¹³

GAAS Requirements

Illegal Acts, Including Violations of Provisions of Contracts or Grant Agreements

4.11 AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), discusses the auditor's responsibilities with respect to the consideration of illegal acts and the communication with those charged with governance.¹⁴ (AU section 317 defines *illegal acts* as violations of laws or government regulations. It generally has been interpreted under GAAS that the term *laws and regulations* in AU section 317 implicitly includes provisions of contracts or grant agreements.) Paragraph .17 of AU section 317 states that the auditor should assure himself or herself that those charged with governance are adequately informed with respect to illegal acts (including violations of provisions of contracts or grant agreements) that come to the auditor's attention. The auditor need not communicate matters that are inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements. If senior management is involved, the auditor should communicate directly with those charged with governance. Chapter 3 of this guide summarizes other requirements of AU section 317 as related to fieldwork. The auditor also should

¹³ Chapter 3 of this guide discusses the auditor's consideration of fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse. Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units (see footnote 1 in paragraph 4.01), the auditor's consideration of fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse in planning, performing, evaluating the results of, and reporting on the audit should address each opinion unit.

¹⁴ Paragraph .17 of AU section 317 permits the communication to be oral or written (with audit documentation if oral), but *Government Auditing Standards* requires the communication to be in writing. See paragraphs 4.16–.21 for a discussion of the applicable *Government Auditing Standards* guidance.

consider the effect of any noncompliance on the financial statements, and should modify the auditor's report on those financial statements as necessary in accordance with AU section 508.

Fraud

4.12 AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), discusses the auditor's responsibilities for fraud, including communications about fraud to management, those charged with governance, and others based on a financial statement audit in accordance with GAAS. Whenever the auditor has determined that there is evidence that fraud may exist, the auditor should bring that matter to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the auditee's organization. The auditor should report directly to those charged with governance (a) fraud involving senior management and (b) fraud, whether caused by senior management or other employees, that causes a material misstatement of the financial statements. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with them about misappropriations perpetrated by lower-level employees. Under GAAS, the disclosure of possible fraud to parties other than the auditee's senior management and those charged with governance ordinarily is not part of the auditor's responsibility and ordinarily would be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose to parties outside the auditee may exist:

- To comply with certain legal and regulatory requirements
- To a successor auditor when the successor makes inquiries in accordance with AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1)
- In response to a subpoena
- To a funding agency or other specified agency in accordance with the requirements for audits of entities that receive governmental financial assistance

The previously listed circumstances encompass financial audits in accordance with *Government Auditing Standards*, which establishes additional reporting requirements relating to fraud. See paragraphs 4.16–21.

4.13 If the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatements due to fraud that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether those risks represent significant deficiencies relating to the auditee's internal control that the auditor should communicate to management and those charged with governance.¹⁵ (See paragraph 4.07.) The auditor also should consider whether the absence of or deficiencies in programs and controls to mitigate specific risks of fraud or to otherwise help prevent, deter, and

¹⁵ Alternatively, the auditor may decide to communicate solely with those charged with governance.

detect fraud represent significant deficiencies that should be communicated to management and those charged with governance. The auditor also may wish to communicate other risks of fraud identified as a result of the assessment of the risks of material misstatements due to fraud.

4.14 Paragraphs .79–.82 of AU section 316 discuss the communication requirements related to fraud as discussed previously. Chapter 3 of this guide summarizes other requirements of AU section 316¹⁶ as they relate to fieldwork.

Abuse

4.15 GAAS does not require the reporting of abuse. *Government Auditing Standards* does require reporting about abuse; see paragraphs 4.16–.21 for a discussion of the requirements.

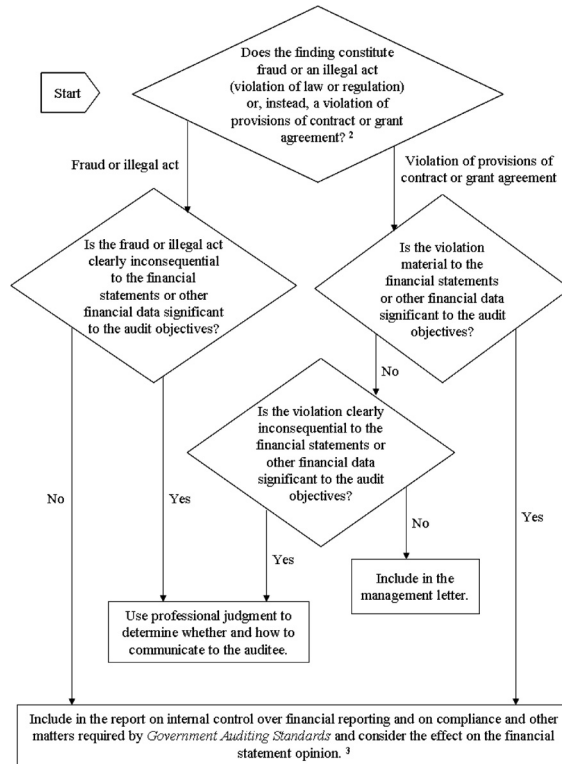
Government Auditing Standards Requirements

4.16 As discussed in paragraph 4.05*b*, paragraph 5.07 of *Government Auditing Standards* requires the auditor to issue a report that describes the scope of the auditor's testing of compliance with laws, regulations, and provisions of contracts or grant agreements and present the results of those tests. As discussed in paragraph 4.05*c*, paragraph 5.10 of *Government Auditing Standards* also states that the auditor should report, as applicable to the objectives of the audit, and based on the audit work performed, (1) all instances of fraud and illegal acts unless inconsequential; and (2) violations of provisions of contracts or grant agreements and abuse that could have a material effect on the financial statements. (See paragraph 4.19 for a discussion of the *Government Auditing Standards* requirement relating to reporting violations of provisions of contracts or grant agreements or abuse that have an effect on the financial statements that is less than material but more than inconsequential.) In addition, in an audit conducted in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133), the auditor should apply a financial statement materiality consideration in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting. That is because those findings already are reported in the Circular A-133 report and reporting findings that are not material to the financial statements again in the *Government Auditing Standards* report would be unnecessarily duplicative. Paragraphs 4.29–.34 describe *Government Auditing Standards* requirements for presenting audit findings. Exhibit 4-1 is a flowchart that illustrates the evaluation and reporting of findings of fraud and noncompliance under *Government Auditing Standards* when the auditee is not subject to an audit in accordance with Circular A-133. (Chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide presents a flowchart that illustrates the evaluation and reporting of findings of fraud and noncompliance under *Government Auditing Standards* when the auditee is subject to an audit in accordance with Circular A-133.) Chapter 3 of this guide includes a flowchart that illustrates its discussion of the evaluation and reporting of findings of abuse.

¹⁶ Chapter 10, "Compliance Auditing Applicable to Major Programs," discusses the auditor's consideration of fraud risk in an audit of an auditee's compliance with specified requirements applicable to its major programs in an audit conducted in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

Exhibit 4-1

Evaluation and Reporting of Findings of Fraud and Noncompliance Under *Government Auditing Standards*¹



¹ This flowchart represents the evaluation and reporting of findings of fraud and noncompliance (illegal acts and violations of provisions of contracts or grant agreements) under *Government Auditing Standards* when the auditee is not subject to an audit in accordance with Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). Chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide presents a flowchart that illustrates the evaluation and reporting of findings of fraud and noncompliance under *Government Auditing Standards* when the auditee is subject to an audit in accordance with Circular A-133.

² The auditor should consider the direct reporting requirement of *Government Auditing Standards*. Paragraphs 4.20–.21 discuss the requirements in paragraphs 5.18–.20 of *Government Auditing Standards* that auditors report fraud and noncompliance directly to parties outside of the auditee in certain circumstances.

³ Paragraph 4.30 discusses how to report noncompliance findings that relate to both internal control over financial reporting and to compliance. Paragraph 4.31 discusses when to report fraud findings in the internal control section of the report or instead in the section on compliance and other matters.

4.17 As indicated in exhibit 4-1, *Government Auditing Standards* has differing standards for including in the report on internal control over financial reporting and on compliance and other matters (a) noncompliance that is an illegal act (that is, violations of law or regulation) as compared to (b) noncompliance that is a violation of provisions of contract or grant agreements. The reporting for (a) is a threshold of "an effect on the financial statements that is more than inconsequential," whereas the reporting for (b) is a higher threshold of "material to the determination of financial statement amounts or other financial data significant to the audit." Consequently, it is important that auditors carefully evaluate whether compliance requirements arise from laws or regulations or, instead, from provisions of contracts or grant agreements. Often, contracts and grant agreements have compliance requirements that are based in law or regulation but those contracts or agreements do not indicate that laws or regulations are the source of the provisions. Further, it may not be apparent whether a document that provides guidance on the provisions of contracts or grant agreements (such as a program management or procedures manual) has the standing of a regulation. The auditor may need to consult with program administrators, grantors, pass-through entities, oversight agencies, legal counsel, or others about the source and standing of compliance requirements.

4.18 When fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse either have occurred or are likely to have occurred, auditors may consult with authorities or legal counsel about whether publicly reporting the information would compromise investigative or legal proceedings. Auditors may limit their public reporting to matters that would not compromise those proceedings (and for example, only report that information that is already a part of the public record).

4.19 As indicated in exhibit 4-1 and in the discussion and flowchart of abuse in chapter 3 of this guide, paragraph 5.16 of *Government Auditing Standards* provides guidance for reporting fraud and illegal acts that are inconsequential, immaterial violations of provisions of contracts or grant agreements, and immaterial abuse. Violations of provisions of contracts or grant agreements or abuse that have an effect on the financial statements that is less than material but more than inconsequential should be communicated in writing to officials of the audited entity. Determining whether and how to communicate to officials of the audited entity fraud, illegal acts, violations of provisions of contract or grant agreements, or abuse that is inconsequential is a matter of professional judgment. Auditors should document such communications. See table 4-1 and paragraph 4.37.

Direct Reporting of Fraud, Illegal Acts, Violations of Provisions of Contracts or Grant Agreements, and Abuse

4.20 Paragraphs 5.18–20 of *Government Auditing Standards* provide guidance on the direct reporting of fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse. *Government Auditing Standards* state that in addition to any legal requirements for the direct reporting of those situations, auditors should report them directly to parties outside of the auditee in the following two circumstances. Auditors should comply with these requirements even if they have resigned or been dismissed from the audit:

- a. When entity management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, auditors should first communicate the failure

to report such information to those charged with governance. If auditors have communicated such situations to those charged with governance and the audited entity still does not report the information to the external parties as soon as practical, then the auditors should report the information directly to the specified external parties.

- b. When entity management fails to take timely and appropriate steps to respond to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that is (1) likely to have a material effect on the financial statements and (2) involves funding received directly or indirectly from a government agency, auditors should first report management's failure to take timely and appropriate steps to those charged with governance. If the audited entity still does not take timely and appropriate steps as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the entity's failure to take timely and appropriate steps directly to the funding agency.

4.21 In both of these situations, auditors should obtain sufficient appropriate audit evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse in accordance with laws, regulations, and funding agreements. If they are unable to do so, the auditors should report the fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse directly, as discussed previously.

Report on the Financial Statements

4.22 The auditor's standard report on the financial statements identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion on the financial statements in an opinion paragraph.¹⁷ See the illustrative reports in appendix A (paragraph 4.51), examples 4-1 and 4-2. The basic elements of the report are¹⁸

- a. a title that includes the word *independent*.
- b. a statement that the financial statements identified in the report were audited.
- c. a statement that the financial statements are the responsibility of the auditee's management and that the auditor's responsibility is

¹⁷ Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units (see footnote 1 in paragraph 4.01), the auditor's report on those financial statements may include more than 1 opinion paragraph.

¹⁸ Paragraphs .85–.88 of Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards" of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), provides wording that may be added to the auditor's standard report on the financial statements of a nonissuer to clarify differences between a GAAS audit and an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB). Paragraphs .89–.92 of Interpretation No. 17 explain how the auditor should report if engaged to also follow PCAOB auditing standards in the audit of a nonissuer. See the further discussion in appendix A (paragraph 4.51).

to express an opinion on the financial statements based on his or her audit.

- d. a statement that the audit was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards) and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.^{19,20} (See paragraph 4.24–.25.)
- e. a statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- f. a statement that an audit includes
 - examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
 - assessing the accounting principles used and significant estimates made by management.
 - evaluating the overall financial statement presentation.
- g. a statement that the auditor believes that the audit provides a reasonable basis for his or her opinion.
- h. an opinion on whether the financial statements are fairly presented, in all material respects, in conformity with GAAP.²¹ The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. GAAP).
- i. a reference to the separate report on internal control over financial reporting and on compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters prepared in accordance with *Government Auditing Standards*,²² which includes a statement that the purpose of that report is to describe the scope of testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. This statement should be modified if the auditor is providing an opinion on internal control over financial reporting or on compliance in the *Government Auditing Standards* report. The reference

¹⁹ The standards applicable to financial audits are the general, fieldwork, and reporting standards described in chapters 3–5 of *Government Auditing Standards*.

²⁰ *Government Auditing Standards*, paragraph 3.04, states that when personal, external, and organizational impairments to independence exist, a government auditor who cannot decline to perform the work because of a legislative requirement or for other reasons should report must disclose the impairment and modify the compliance statement.

²¹ If an auditee prepares OCOA financial statements, the auditor still is required to express or disclaim an opinion and should follow the reporting in AU section 623. See also footnote 3 in paragraph 4.03.

²² Paragraphs 4.04, 4.08–.10, and 4.27–.28 discuss the report on internal control over financial reporting and on compliance and other matters based on a financial statement audit in accordance with *Government Auditing Standards*.

also should include a statement that the separate report is an integral part of an audit performed in accordance with *Government Auditing Standards* and important for assessing the results of the audit. If the reporting on internal control over financial reporting and on compliance and other matters is included in the report on the financial statements, the reference to the separate report is not required. (This guide recommends separate reporting; see paragraph 4.05*b*.)

- j. the manual or printed signature of the auditor's firm.
- k. the date of the audit report.

4.23 As discussed in paragraph 4.03, various professional standards provide reporting guidance if the basic financial statements are accompanied by or required to be accompanied by information presented outside the basic financial statements. Those standards may require additional language in the auditor's report on the financial statements. The illustrative report in appendix A (paragraph 4.51), example 4-1, includes paragraphs reporting on RSI and SI.²³

4.24 As discussed in paragraph 4.05*a*, when the report on the financial statements is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, or when those standards are voluntarily followed, the report should include a *Government Auditing Standards* compliance statement. An unmodified compliance statement should be used when the auditor has (a) followed all applicable unconditional and presumptively mandatory *Government Auditing Standards* requirements or (b) have followed all unconditional requirements and documented justification for any departure from applicable presumptively mandatory requirements and have achieved the objectives of those requirements through other means. This guide recommends the following language be included in the auditor's report to meet this requirement: "We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States."

4.25 A modified compliance statement should be used when the requirements for the unmodified compliance statement are not met. One situation the auditor should consider using a modified compliance statement is in the case of a scope limitation, such as restrictions on access to records, government officials, or other individuals needed to conduct the audit. When a modified compliance statement is used, the auditor should disclose the applicable requirement(s) that was not followed, the reason for not following the requirement(s), and how not following the requirement(s) affected, or could have affected, the audit and the assurance provided. A modified compliance statement is made by stating that (1) the auditor performed the audit in accordance with *Government Auditing Standards*, except for specific applicable requirements that were not followed, or (2) because of the significance of the departure(s) from the requirements, the auditor was unable to and did not perform the audit in accordance with *Government Auditing Standards*. When the auditors do not comply with any applicable requirements, they should (1) assess the significance of the non-compliance to the audit objectives, (2) document the assessment, along with

²³ Chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide discusses and illustrates auditor reporting on the supplementary schedule of expenditures of federal awards required by Circular A-133.

their reasons for not following the requirement, and (3) determine the type of *Government Auditing Standards* compliance statement. The auditor's determination will depend on the significance of the requirements not followed in relation to the audit objectives.

4.26 Paragraph 5.06 of *Government Auditing Standards* acknowledges that an auditee may need a financial statement audit for purposes other than to comply with a requirement calling for an audit in accordance with *Government Auditing Standards*. For example, the auditee may need a financial statement audit to issue bonds, or for other financing purposes. In that case, *Government Auditing Standards* permits auditors to issue a separate report on the financial statements conforming only to the requirements of GAAS.²⁴

Report on Internal Control Over Financial Reporting and Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

4.27 This guide recommends combining into one report the reporting required by *Government Auditing Standards* on the scope and results of testing of the auditee's internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements and other matters, which concern certain fraud and abuse. (Paragraph 4.31 discusses the placement of findings relating to "other matters.")

4.28 The following lists the basic elements of the auditor's standard report on internal control over financial reporting and on compliance and other matters based on an audit of the financial statements in accordance with *Government Auditing Standards*. See the illustrative reports in appendix A (paragraph 4.51), examples 4-3 and 4-5, and the discussion of the presentation of findings and the views of responsible officials and their planned corrective actions in paragraphs 4.29–.36:

- a. A statement that the auditor has audited the financial statements of the auditee and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report (see appendix A (paragraph 4.51), examples 4-4 and 4-6 for illustrations acknowledging that the financial statement report was modified to include a reference to other auditors and the related discussion in paragraphs 4.42–.48).
- b. A statement that the audit was conducted in accordance with GAAS and an identification of the United States of America as the country

²⁴ The AICPA Audit and Accounting Guide *State and Local Governments* discusses auditor association with municipal securities filings and the use of *Government Auditing Standards* reports and references in the offering document—the official statement. Governments sometimes issue municipal securities to finance facilities for nongovernmental organizations, such as not-for-profit and health care organizations, and those nongovernmental organizations may be considered "obligated persons" with regard to the securities and thus also provide audited financial statements for the official statement. The AICPA Audit and Accounting Guide *State and Local Governments* states that the official statement should not include the reports required by *Government Auditing Standards* because those reports are restricted-use reports under the provisions of AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1). Further, that guide states that it generally is advisable for the official statements to use an auditor's report on the financial statements that does not refer to the *Government Auditing Standards* audit or to those reports.

of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards) and with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. (See paragraphs 4.24–.25.)

- c. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide an opinion on the internal control over financial reporting, and accordingly, does not express an opinion on the effectiveness of the auditee's internal control over financial reporting.²⁵
- d. The definition of control deficiency and significant deficiency. If applicable, a statement that deficiencies were identified that are considered to be significant deficiencies in internal control over financial reporting.
- e. A statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be significant deficiencies or material weaknesses; if significant deficiencies are noted, a statement that certain deficiencies in internal control over financial reporting were identified that the auditor considers to be significant deficiencies.
- f. If applicable, a description of the significant deficiencies identified (including the views of responsible officials and their planned corrective action) or a reference to a separate schedule in which significant deficiencies, views of responsible officials, and their planned corrective action are described.²⁶
- g. The definition of a material weakness.
- h. If no significant deficiencies are identified, a statement that no material weaknesses were noted. If significant deficiencies are noted, a statement that the auditor's consideration of internal control over financial reporting would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and a statement about whether the auditor believes any of the significant deficiencies noted are material weaknesses.
- i. A statement that as part of obtaining reasonable assurance about whether the auditee's financial statements are free of material misstatement, the auditor performed tests of the auditee's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.
- j. A statement that providing an opinion on compliance with those provisions was not an objective of the audit and that, accordingly, the auditor does not express such an opinion.

²⁵ See footnote 6 in paragraph 4.05. This statement should be modified if the auditor is providing an opinion on internal control over financial reporting.

²⁶ For an audit in accordance with Circular A-133, all findings, including those required to be reported under *Government Auditing Standards*, should be included in the schedule of findings and questioned costs. See the further discussion in chapter 12 of this guide.

- k. A statement that notes whether the results of tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*²⁷ and, if they are, describes the instances of noncompliance and other matters (including the views of responsible officials and their planned corrective action) or refers to the separate schedule in which the noncompliance and other matters, views of responsible officials, and their planned corrective action are described. When the views of responsible officials are included (auditee's written response), also include a statement that the auditor did not audit the auditee's response and, accordingly, expresses no opinion on it.
- l. If applicable, a statement that additional matters were communicated to the auditee in a management letter.²⁸
- m. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of management, [identifying the body or individuals charged with governance], others within the entity, and [identifying the legislative or regulatory body]²⁹ and is not intended to be and should not be used by anyone other than these specified parties.³⁰
- n. The manual or printed signature of the auditor's firm.
- o. The date of the auditor's report. (Because the report on internal control over financial reporting and on compliance and other matters relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should carry the same date as the auditor's report on the financial statements.)

Other Reporting and Communication Considerations

Findings Relating to the Financial Statements³¹

4.29 As summarized in table 4-1, paragraph 5.10 of *Government Auditing Standards* states that the auditor should include findings for the following situations in the report on internal control over financial reporting and on compliance and other matters:

- Significant deficiencies in internal control over financial reporting (those that are, individually or in the aggregate, material weaknesses should be identified as such)

²⁷ Paragraph 4.16 discusses noncompliance and other matters—certain fraud and abuse—for which *Government Auditing Standards* requires reporting in the auditor's report. Paragraph 4.31 discusses where to report findings of fraud and abuse in the report on internal control over financial reporting and on compliance and other matters.

²⁸ Paragraph 4.37 discusses the *Government Auditing Standards* requirements for communicating in writing immaterial violations of provisions of contracts or grant agreements and immaterial abuse to officials of the audited entity.

²⁹ For an audit in accordance with Circular A-133, this reference should include federal awarding agencies and, if applicable, pass-through entities. See the further discussion in chapter 12 of this guide.

³⁰ This paragraph conforms to AU section 532. See AU section 532 for additional guidance on restricted-use reports.

³¹ There is no option for the auditor to report in a management letter, or other written communication, findings that *Government Auditing Standards* or Circular A-133 requires to be reported in the auditor's report or Schedule of Findings and Questioned Cost.

- All instances of fraud and illegal acts unless inconsequential³²
- Material violations of provisions of contracts and grant agreements
- Material abuse

4.30 As indicated in paragraph 4.28, the report on internal control over financial reporting and on compliance and other matters should either describe the findings indicated in paragraph 4.29 or refer to a separate schedule that describes them. (As discussed in paragraph 4.35, the auditor also should include the reporting of the auditee's views and planned corrective action.) Findings that relate to both internal control over financial reporting and to compliance are generally reported in both the section of the report concerning internal control over financial reporting and the section of the report concerning compliance and other matters. However, the reporting in one section of the report or schedule may be in summary form with a reference to a detailed reporting in the other section.

4.31 This guide recommends that the auditor present or refer to findings of fraud and abuse in the compliance and other matters section of the report, unless the primary nature of the finding is a significant deficiency in internal control. In that case, it is recommended that findings of fraud and abuse that represent significant deficiencies in internal control be presented in the internal control section. Neither *Government Auditing Standards* nor this guide requires the auditor's report to use the terms *fraud* or *abuse* in presenting or referring to such findings. The illustrative reports in example 4-3 and example 4-4 in appendix A (paragraph 4.51) illustrate language in the compliance and other matters section of the report to refer to findings that do or may include fraud and abuse. This guide recommends that this language appear in all reports, even if the report does not describe or refer to findings of fraud or abuse or even if the only findings of fraud or abuse are described in or referred to from the section on internal control over financial reporting.

4.32 Paragraph 5.22 of *Government Auditing Standards* states that auditors should place their findings in proper perspective by describing the nature and extent of the issues being reported and the extent of the work performed that resulted in the finding. To give the reader a basis to judge the prevalence and consequences of the findings, the instances that are identified should be related to the population or the number of cases examined and be quantified in terms of dollar value or other measure, as appropriate. If the results can not be projected, auditors should limit their conclusions appropriately.

4.33 In presenting audit findings, paragraph 5.21 of *Government Auditing Standards* states that auditors should develop the elements of the findings to the extent necessary to achieve the audit objectives. The elements of a finding are (a) criteria (the required or desired state), (b) condition (the situation that exists), (c) cause (why it happened), and (d) effect or potential effect (the difference between the situation that exists and the required or desired state).

³² As discussed in paragraph 4.16, for an auditee that is subject to an audit in accordance with Circular A-133, the auditor should apply a financial statement materiality consideration in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting. That is because those findings already are reported in the Circular A-133 report and reporting findings that are not material to the financial statements again in the *Government Auditing Standards* report would be unnecessarily duplicative. Chapter 12 of this guide discusses that reporting.

Paragraphs 4.15–.18 of *Government Auditing Standards* further describe those 4 elements. Clearly developed findings assist management or oversight officials of the audited entity in understanding the need for taking corrective action. In addition, if auditors sufficiently develop the elements of a finding, they may provide recommendations for corrective action.

4.34 This guide recommends that each audit finding reported in accordance with *Government Auditing Standards* explicitly address each of the elements referred to previously to the extent necessary to achieve the audit objective and that each finding be assigned a reference number.³³ One option for assigning reference numbers is to use the fiscal year being audited as the beginning digits of each reference number, followed by a numeric sequence. For example, findings identified and reported in the audit of fiscal year 20X1 would be assigned reference numbers 20X1-1, 20X1-2, and so forth.

Reporting Views of Responsible Officials and Planned Corrective Action

4.35 As discussed in paragraph 4.05f, if the auditor's report includes findings, paragraph 5.32 of *Government Auditing Standards* states that auditors should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions.³⁴ Auditors should include in their report a copy of the officials' written comments or a summary of the comments received. Auditors should also include in the report an evaluation of the comments, as appropriate. Obtaining the comments in writing is preferred, but oral comments are acceptable. When the auditor receives oral comments, the auditor should summarize those comments and provide a copy of the summary to the entity's officials to verify their accuracy before finalizing the report. Paragraph 5.37 of *Government Auditing Standards* provides that if the auditee's comments are inconsistent with or in conflict with the report's findings, conclusions, or recommendations, and are not, in the auditor's opinion, valid—or if the planned corrective actions do not adequately address the auditor's recommendations—the auditor should state reasons for disagreeing with the comments or planned corrective actions.³⁵ Conversely, if the auditors find the comments valid and supported by sufficient appropriate evidence, they should modify their report as necessary. When a written response to the auditor's findings are included in a report, the auditor should add a statement disclaiming an opinion on such information. An example of such a statement is "[Insert Entity's name]'s written response to the significant deficiencies [and material weaknesses] identified in our audit has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it."

4.36 If the audited entity refuses to provide comments or is unable to provide them within a reasonable amount of time, *Government Auditing*

³³ As discussed in chapter 12 of this guide, when performing a Circular A-133 audit, Circular A-133 requires all findings (including findings related to the audit of the financial statements for which *Government Auditing Standards* requires reporting) to have a reference number.

³⁴ As discussed in chapter 2 of this guide, the auditor should consider establishing an understanding with auditee in the engagement letter about the need and timing for developing the views of responsible officials and planned corrective action.

³⁵ In an audit in accordance with Circular A-133, the auditee is required to submit a corrective action plan. For those audits, depending on the status of the development of the corrective action plan at the time the auditor's reports are released, the auditor may be able to refer to the corrective action plan to satisfy as the required presentation of the auditee's views and planned corrective actions. See the further discussion in chapter 12 of this guide.

Standards states that the auditor may issue the report without receiving comments from the audited entity. If, however, the auditee does not provide the necessary information by the time the report is released, the report should indicate that the audited entity did not provide comments.

Other Written Communications

4.37 Paragraphs 5.16 of *Government Auditing Standards* states that auditors should communicate in writing violations of provisions of contracts or grant agreements or abuse that have an effect on the financial statements that is less than material but more than inconsequential (see table 4-1).^{36,37} This communication may be done in a management letter. As noted in paragraph 5.09 of *Government Auditing Standards*, if auditors issue or intend to issue a management letter that contains items required to be communicated to entity officials, they should refer to that management letter in the report on internal control over financial reporting and on compliance and other matters. As discussed in paragraph 4.49, auditors should not include personal identification or other potentially sensitive matters in the management letter. Examples 4-3 and 4-5 in appendix A (paragraph 4.51) illustrate references to the management letter. *Government Auditing Standards* directs auditors to use professional judgment to determine whether and how to communicate to auditee officials fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that is inconsequential.³⁸ Paragraph 5.16 of *Government Auditing Standards* states that auditors should document such communications.

4.38 Auditors often use a management letter to communicate information to the auditee about ways to improve operational efficiency and effectiveness or otherwise improve internal control or other policies or procedures (other than those for which communication is required by GAAS or *Government Auditing Standards*). In communicating information in a management letter, auditors could consider wording the discussions so that readers can distinguish those matters that are required to be included by GAAS or *Government Auditing Standards* from matters that are recommendations for improvements or information about "best practices." When a management letter is issued only for the purpose of providing management with efficiency comments or to communicate nonsignificant deficiencies (and does not contain any items required to be communicated under *Government Auditing Standards*), a reference to the management letter does not need to be put in the auditor's reports.

Portions of the Entity Not Audited in Accordance With *Government Auditing Standards*

4.39 Because of the provisions of GAAP, entities that are required to have an audit in accordance with *Government Auditing Standards* sometimes include in their financial statements organizational units that are not required to

³⁶ Generally, *Government Auditing Standards* requires the auditor to evaluate findings for the purpose of this communication based on their consequence to the financial statements or other financial data significant to the audit objectives. As discussed in chapter 12 of this guide, however, in an audit in accordance with Circular A-133, the auditor should evaluate findings involving federal awards for the purpose of that communication based only on their consequence to the financial statements.

³⁷ See footnote 31 at the heading before paragraph 4.29.

³⁸ As discussed in paragraph 4.12, AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), whenever the auditor has determined that there is evidence that fraud may exist, the auditor should bring that matter to the attention of an appropriate level of management, even if the matter might be considered inconsequential.

have such an audit. For example, Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, as amended, requires reporting entity financial statements to include component units. Similarly, Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), requires presentation of consolidated financial statements when one not-for-profit organization (NPO) (the parent) controls the voting majority of the board of directors and has an economic interest in another NPO. When included organizational units do not have an audit in accordance with *Government Auditing Standards*, the auditor should consider modifying his or her reports on the financial statements and on internal control over financial reporting and on compliance and other matters, as discussed below.

4.40 With regard to the report on the financial statements of a governmental reporting entity, consolidated NPO, or other consolidated entity, if a material portion of the organization (such as a component unit or fund³⁹) is not required to have an audit in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on the financial statements to indicate the portion of the entity that was not audited in accordance with *Government Auditing Standards*. Example wording follows:

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of [name of the portion of the entity, such as the name of the component unit or fund]⁴⁰ were not audited in accordance with *Government Auditing Standards*. An audit includes examining....

4.41 With regard to the report on the internal control over financial reporting and on compliance and other matters, the auditor should modify the opening scope paragraph to indicate the portion of the entity that was not audited in accordance with *Government Auditing Standards*. Example wording for a state or local government follows:

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of Example Entity as of and for the year ended June 30, 20X1, which collectively comprise Example Entity's basic financial statements and have issued our report thereon dated August 15, 20X1. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards

³⁹ Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units (see footnote 1 in paragraph 4.01), the auditor's consideration of materiality in this instance should be considered in terms of the materiality of the component unit or fund to its related opinion unit. See that guide for further guidance.

⁴⁰ For audits of a state or local government's financial statements, if it is not evident from the financial statements to which opinion unit the component unit or fund relates, the auditor should consider identifying the opinion unit in addition to the name of the component unit or fund.

applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The financial statements of [name of component unit or fund] were not audited in accordance with *Government Auditing Standards*.

Other Auditors

4.42 AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1), and paragraphs .12–.13 of AU section 508 provide requirements and guidance regarding the report on the financial statements when more than 1 independent auditor is involved in an audit of an entity's financial statements.

4.43 A principal auditor who refers to the work of other auditors in the report on an entity's financial statements also should acknowledge the involvement of the other auditors in the report on internal control over financial reporting and compliance and other matters issued for that entity. The principal auditor has two options for making such an acknowledgement:

1. Referring to the other auditors involvement in the principal auditor's report and indicating that the results of the other audits are not included—the *reference option*.
2. Referring to the other auditors involvement in the principal auditor's report and including the results of the other audits (for example, material weaknesses, material instances of noncompliance, significant deficiencies, and abuse)—the *inclusion option*.

Regardless of which of the above options is chosen by the auditor, the principal auditor is not responsible for the specific findings of the other auditors.

4.44 The reference option and the inclusion option are equally acceptable. When planning the engagement, the principal auditor should consider discussing with the auditee how other auditors' results will be addressed in the principal auditor's report on internal control over financial reporting and compliance and other matters. The principal auditor also may want to discuss with the auditee and with the other auditors the timing of reports from other auditors to ensure an understanding of expectations. This guide recommends that the principal auditor use only one option in a report (that is, not referencing the results of some other auditors' work and including the results of others). Paragraphs 4.45–.48 describe considerations relating to the inclusion option. Appendix A (paragraph 4.51), example 4-4 provides illustrative report wording for the reference option and example 4-6 provides illustrative wording for the inclusion option.

4.45 When relying on the reports of other auditors for the fair presentation of basic financial statements, the principal auditor often has to take steps to ensure other auditors' reports are issued timely so that the principal auditor's report on the fair presentation of the reporting entity's financial statements can be issued timely. The same effort also is necessary for the report on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards* when the principal auditor chooses to use the inclusion option and include other auditors' results. Communication, planning, establishing deadlines, and monitoring are important to ensure that the issuance of the principal auditor's report is not delayed because one or more other auditors have not issued their reports. Establishing and successfully

implementing this approach calls for coordination with both the auditee and the other auditors.

4.46 The principal auditor's decision to use the inclusion option may be affected by various factors that may complicate the gathering and assessment of other auditors' work. For example, large governments may have many component units audited by other auditors and the principal auditor may need to obtain, analyze, and include numerous results from other auditors' reports. Further, the other auditors' reports on internal control over financial reporting and compliance and other matters may not be issued in final form when the principal auditor's report is issued. Finally, the audits performed by other auditors may not be performed under *Government Auditing Standards*.⁴¹

4.47 With both options, the principal auditor's report on internal control over financial reporting and compliance and other matters should identify the organizations, functions, or activities audited by other auditors and whether any of those audits were not performed under *Government Auditing Standards*⁴² in the introductory paragraph as well as refer to the principal auditor's report on the financial statements:

- a. With the reference option, ordinarily the introductory paragraph also states that the report on internal control over financial reporting and compliance and other matters does not include the results of the audits performed by other auditors.
- b. With the inclusion option, the principal auditor analyzes the results of the other audits to determine which findings, if any, may be included in the principal auditor's report on internal control over financial reporting and compliance and other matters. The principal auditor exercises professional judgment in evaluating those results for inclusion using the materiality levels appropriate for the scope of for the principal auditor's audit. For example, an internal control weakness that is a significant deficiency at the organizational unit level when it is separately audited may not rise to the level of a significant deficiency when considered in the context of materiality for the entity covered by the principal auditor's audit. Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units (see footnote 1 in paragraph 4.01), the auditor's consideration of the results of the other audits should address each opinion unit. Table 4-3 provides guidance to assist the principal auditor in exercising judgment in this analysis process for an audit of a government taking into consideration the opinion unit concept.

⁴¹ For situations in which the other auditors did not perform their audits under *Government Auditing Standards*, there is nothing to preclude the principal auditor from including in the report on internal control over financial reporting and on compliance and other matters the significant deficiencies and material weaknesses that the other auditors communicated to meet the requirements of AU section 325A. However, if such AU section 325A communication is included, this guide recommends that the opening paragraph of example 4-6 in appendix A be modified to explain that, while certain of the audits were not performed under *Government Auditing Standards*, the control deficiencies from those audits are included in the reporting.

⁴² See appendix A (paragraph 4.51), example 4-4, footnotes 38–39, and example 4-6 for illustrations of the report wording in situations where some or all of the other auditor's audits were not performed under *Government Auditing Standards*.

Table 4-3**Inclusion Option: Guidance for Determining Whether to Include the Other Auditors' Findings in the Principal Auditor's Report on Internal Control Over Financial Reporting and Compliance and Other Matters for an Audit of a Government**

| The Other Auditors Perform the Audit of: | The Other Auditors' Reports Include Material Weakness(es), Material Noncompliance, or Material Abuse | The Other Auditors Reports Include Significant Deficiencies | The Other Auditors Reported Matters Required by <i>Government Auditing Standards</i> to be communicated in writing¹ |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------|
| One or more complete opinion units (for example, the other auditors report on the financial statements of a major fund or of the aggregate discretely presented component unit opinion unit in its entirety) | Include the other auditors' findings in the principal auditor's report ² | Include the other auditors' findings in the principal auditor's report | Exclude the other auditors' findings from the principal auditor's report |
| Material portion of an opinion unit (for example, the other auditors report on the financial statements of a department that is a material portion of the financial statements of a major fund or the other auditor audits a discretely presented component unit that is material to the aggregate discretely presented component unit opinion unit) | Include the other auditors' findings in the principal auditor's report | Use professional judgment in considering whether to include the other auditors' findings in the principal auditor's report | Exclude the other auditors' findings from the principal auditor's report |

(continued)

| | | | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------|
| <p>Immaterial portion of an opinion unit (for example, the other auditors report on the financial statements of component units that are an immaterial portion of the aggregate discretely presented component unit opinion unit)</p> | <p>Use professional judgment in considering whether to include the other auditors' finding in the principal auditor's report ³</p> | <p>Use professional judgment in considering whether to include the other auditors' findings in the principal auditor's report</p> | <p>Exclude the other auditors' findings from the principal auditor's report</p> |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------|

¹ As noted in paragraph 4.37, *Government Auditing Standards* require the auditor to communicate in writing violations of provisions of contracts or grant agreements or abuse that have an effect on the financial statements that is less than material but more than inconsequential. Such communication may be made in a management letter. Paragraph 5.09 of *Government Auditing Standards* states that the auditor's report on internal control and on compliance and other matters should refer to the management letter. Therefore, for situations where the principal auditor or the other auditors have issued management letters that include matters required to be reported under *Government Auditing Standards*, the principal auditor's report should include a reference to its own management letter, as well as those of the other auditors. Appendix A (paragraph 4.51), example 4-6 provides illustrative report wording for this situation.

² For example, if the other auditor reports a material weakness or material noncompliance for a major enterprise fund's stand alone financial statements, the principal auditor would include that material weakness or material noncompliance in the principal auditor's report.

³ For example, if the other auditor reports a material weakness for a nonmajor enterprise fund's stand alone financial statements, the principal auditor would consider the nature and significance of the material weakness in relation to the aggregate remaining fund information opinion unit in its entirety to determine whether to include that material weakness in the principal auditor's report.

4.48 For those material weaknesses, material instances of noncompliance, significant deficiencies, and abuse the principal auditor decides to include in the report, the auditor normally would include the description of the other auditors' results exactly as reported by the other auditors. However, in some circumstances the principal auditor may make minor changes to the descriptions of material weaknesses, material instances of noncompliance, significant deficiencies, and abuse (for example, to add clarity and perspective). Before making any changes to such descriptions in the principal auditor's report, the auditor may consider discussing the proposed changes with the other auditors and document the results of that discussion. The principal auditor uses professional judgment in determining how best to organize the reporting of results of other auditors. For example, the principal auditor might organize the results by who identified them, describing the principal auditor's results first followed by the results of other auditors. If the principal auditor decides to organize all of the findings by subject matter or level of importance, the principal auditor could add appropriate language to each of the other auditors' results to make it clear which matters were identified by other auditors.

Freedom of Information Act and Similar Laws and Regulations

4.49 Often, federal, state, and local laws and regulations, such as the Freedom of Information Act (U.S. Code title 5, section 552), require governments to release certain documents, including audit reports and management letters of organizations for which the government has oversight responsibilities, to members of the press and the general public. Other laws and regulations require that audit reports of governments be made publicly available. Accordingly, auditors should not include names, Social Security numbers, other personal identification, or other potentially sensitive matters in either the body of audit reports or any attached or referenced schedules or letters. Paragraph 5.39 of *Government Auditing Standards* states that if certain pertinent information is prohibited from public disclosure or is excluded from a report due to the confidential or sensitive nature of the information, auditors should disclose in the report that certain information has been omitted and the reason or other circumstances that make the omission necessary.

Assurance to Regulators and Oversight Agencies

4.50 Federal and state regulators and other oversight agencies sometimes require that independent auditors sign a document, such as a standardized form or questionnaire, to provide some level of assurance about an auditee's financial or other data or systems. Auditors may only provide assurance about such data and systems in a manner that complies with applicable professional standards. In addition, auditors may refer to interpretations of AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 9501), for procedures and reporting standards concerning surveys about the effectiveness (suitability) of the design of an entity's internal control as part of the process of applying for a government grant or contract (pre-award surveys).

4.51

Appendix A—Illustrative Auditor’s Reports Under Government Auditing Standards

A-1. This appendix contains examples of the reports issued under generally accepted auditing standards (GAAS) and *Government Auditing Standards* in various circumstances. As discussed previously in this chapter, *Government Auditing Standards* requires that in addition to providing an opinion or a disclaimer of opinion on the financial statements,¹ auditors should report on the scope and results of testing of the auditee’s internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. They also should report certain fraud or abuse. Auditors should exercise professional judgment in any situation not specifically addressed in this guide. For additional guidance the auditor should refer to AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), and applicable AICPA Audit and Accounting Guides, such as *Health Care Organizations, Not-For-Profit Organizations, and State and Local Governments*. The following is a list of the example reports in this appendix:

| <i>Example No.</i> | <i>Title</i> |
|--------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4-1 | Unqualified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Supplementary Information—State or Local Governmental Entity |
| 4-2 | Unqualified Opinion on Financial Statements—Not-for-Profit Organization |
| 4-3 | Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards (No Material Weaknesses [No Significant Deficiencies Identified], No Reportable Instances of Noncompliance or Other Matters)</i> |
| 4-4 | Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards (for a Governmental Entity and With Reference to Audits by Other Auditors Using the Reference Option) (No Material Weaknesses [No Significant Deficiencies Identified], No Reportable Instances of Noncompliance or Other Matters)</i> |
| 4-5 | Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards (Significant Deficiencies, Reportable Instances of Noncompliance, and Other Matters Identified)</i> |

¹ As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government’s basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. In addition, the auditor may provide opinions or disclaimers of opinions on additional opinion units if engaged to set the scope of the audit and assess materiality at a more detailed level than by the opinion units required for the basic financial statements. Throughout this guide, the use of the singular terms *opinion* and *disclaimer of opinion* encompasses the multiple opinions and disclaimers of opinion that generally will be provided on a government’s financial statements.

| <i>Example No.</i> | <i>Title</i> |
|--------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4-6 | <i>Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards (for a Governmental Entity and With Reference to Audits by Other Auditors Using the Inclusion Option) (Significant Deficiencies, Reportable Instances of Noncompliance, and Other Matters Identified)</i> |

Example 4-1

Unqualified Opinions on Basic Financial Statements Accompanied by Required Supplementary Information and Supplementary Information—State or Local Governmental Entity²

Independent Auditor's Report

[Addressee]

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,³ 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. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.]⁴ An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.⁵

² Auditors should refer to the AICPA Audit and Accounting Guide *State and Local Governments* for additional guidance on reporting on a government's basic financial statements. In particular, appendix A to chapter 14 of that guide describes conditions that may make modifications of the standard report necessary and illustrates several of those modifications, such as reference to the work of other auditors.

³ The standards applicable to financial audits are the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

⁴ This optional wording may be added in accordance with paragraphs .85–.88 of Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. It also addresses how auditors may expand this report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional wording is added, in an audit of a governmental entity, the remainder of the paragraph should read as follows:

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

⁵ If the financial statements include organizational units that are not required to have a *Government Auditing Standards* audit, the auditor should consider modifying this scope paragraph as discussed and illustrated in paragraphs 4.39–.40.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of the City of Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters.⁶ The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance.⁷ That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The [identify accompanying required supplementary information, such as management's discussion and analysis and budgetary comparison information] on pages XX through XX and XX through XX are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America.⁸ We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.⁹

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The [identify accompanying supplementary information, such as the introductory section, combining and individual nonmajor fund financial statements, and statistical tables] are presented for purposes of additional analysis and are not a required part of the basic financial statements.¹⁰ The [identify relevant supplementary information, such as the combining and individual

⁶ Paragraph 4.16 discusses noncompliance and other matters—certain fraud and abuse—for which *Government Auditing Standards* requires reporting in the auditor's report.

⁷ This sentence should be modified if the auditor is providing an opinion on internal control over financial reporting or on compliance in the *Government Auditing Standards* report. See footnote 6 to paragraph 4.05b.

⁸ The auditor may identify the body requiring the information, which in this situation is the Governmental Accounting Standards Board (GASB).

⁹ Generally accepted accounting principles (GAAP) require that the financial statements of state and local governments be accompanied by a management's discussion and analysis, and may require that they be accompanied by other required supplementary information (RSI). The auditor may be required to or choose to report on that information. This example assumes such reporting. AU section 558, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1); AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1); and the AICPA Audit and Accounting Guide *State and Local Governments* contain guidance on the auditor's responsibilities for and reporting on RSI.

¹⁰ If the financial statements are accompanied by supplementary information other than RSI (known as SI), the auditor may be required to or choose to report on that information. This example assumes such reporting. AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1); AU section 551; and the AICPA Audit and Accounting Guide *State and Local Governments* contain guidance on the auditor's responsibilities

(continued)

nonmajor fund financial statements] have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.¹¹ The [*identify relevant supplementary information, such as the introductory section and statistical tables*] have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

[Signature]

[Date]

(footnote continued)

for and reporting on SI. In addition, in an audit in accordance with Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the financial statements should be accompanied by a supplementary schedule of expenditures of federal awards and the auditor should report whether that schedule is presented fairly in all material respects in relation to the financial statements taken as a whole. Chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide illustrates wording for this paragraph in that situation.

¹¹ When reporting on SI, the auditor should consider the effect of any modifications to the report on the basic financial statements (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors). Furthermore, if the report on SI is other than unqualified, this paragraph should be modified. Paragraphs .09–.11 and .13–.14 of AU section 551 provide guidance for reporting in these circumstances.

Example 4-2**Unqualified Opinion on Financial Statements—Not-for-Profit Organization¹²**Independent Auditor's Report

[Addressee]

We have audited the accompanying statement of financial position of Example NPO as of June 30, 20X1, and the related statements of activities and cash flows¹³ for the year then ended. These financial statements are the responsibility of Example NPO's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,¹⁴ 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. [Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Example NPO's internal control over financial reporting. Accordingly, we express no such opinion.]¹⁵ An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.¹⁶

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Example NPO as of June 30, 20X1, and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example NPO's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters.¹⁷ The purpose of that report is to describe the scope of our testing

¹² Auditors also should refer to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* for additional guidance on reporting on the financial statements of a not-for-profit organization. In addition to the situations discussed in that guide, auditors may need to modify the report on the financial statements to refer to the work of other auditors, using the guidance in AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1).

¹³ Each of the statements presented, which may include a statement of functional expenses, should be identified in the introductory paragraph.

¹⁴ See footnote 3.

¹⁵ See footnote 4. If this optional wording is added, in an audit of a nongovernmental entity, the remainder of the paragraph should read as follows:

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

¹⁶ See footnote 5.

¹⁷ See footnote 6.

of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance.¹⁸ That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.¹⁹

[Signature]

[Date]

¹⁸ See footnote 7.

¹⁹ If the financial statements are accompanied by RSI or SI (for example, a comparison of actual and budgeted expenses), the auditor may be required to or choose to report on that information in one or more paragraphs following this paragraph. AU section 550; AU section 551; and AU section 558 contain guidance on the auditor's responsibilities for and reporting on RSI and SI. See also footnote 11. In addition, in an audit in accordance with Circular A-133, the financial statements should be accompanied by a supplementary schedule of expenditures of federal awards and the auditor should report whether that schedule is presented fairly in all material respects in relation to the financial statements taken as a whole. Chapter 13 of this guide illustrates wording for this paragraph in that situation.

Example 4-3

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters²⁰ Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (No Material Weaknesses [No Significant Deficiencies Identified], No Reportable Instances of Noncompliance or Other Matters)²¹

[Addressee]

We have audited the financial statements²² of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1.²³ We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,²⁴ issued by the Comptroller General of the United States.²⁵

Internal Control Over Financial Reporting^{26,27}

In planning and performing our audit, we considered Example Entity's internal control over financial reporting as a basis for designing our auditing procedures

²⁰ Chapters 2, "Planning Considerations of *Government Auditing Standards*," and 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide discuss the auditor's consideration of internal control over financial reporting and of fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse.

²¹ The auditor should use the portions of examples 4-3 and 4-5 that apply to a specific auditee situation. For example, if the auditor has identified significant deficiencies but has not identified instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, the internal control section of example 4-5 would be used along with the compliance and other matters section of this report. Alternatively if the auditor has not identified significant deficiencies but has identified instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, the internal control section of this report would be used along with the compliance section of example 4-5.

²² As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government's basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. (See footnote 1.) For audits of governmental entities, the first sentence in this report should be modified to reflect the opinion units that have been reported on. In addition, the first sentence under the heading "Internal Control over Financial Reporting" should be revised to refer to "our opinions" instead of "our opinion." An illustration of the revised wording for the first sentence follows:

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of Example Entity as of and for the year ended June 30, 20X1, which collectively comprise Example Entity's basic financial statements and have issued our report thereon dated August 15, 20X1.

²³ Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors).

²⁴ See footnote 3.

²⁵ If the financial statements include organizational units that are not required to have a *Government Auditing Standards* audit, the auditor should consider modifying this scope paragraph as discussed and illustrated in paragraphs 4.39 and 4.41.

²⁶ *Government Auditing Standards* permits, but does not require, auditors to express an opinion on internal control over financial reporting or on compliance if sufficient work was performed.

²⁷ This report sequences the reporting on internal control over financial reporting before the reporting on compliance and other matters. However, the Circular A-133 reports in appendixes A in chapters 12 and 13, "Program-Specific Audits," of this guide sequence the reporting on compliance before the reporting on internal control over compliance. Auditors may present the internal control and compliance sections of the *Government Auditing Standards* and Circular A-133 reports in whichever sequence better meets their needs.

for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over financial reporting.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters²⁸

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of Example Entity in a separate letter dated August 15, 20X1.²⁹

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity,

²⁸ *Other matters* are certain findings of fraud or abuse. This heading and the reference to other matters in the following paragraph should appear in all reports, even if the report does not present or refer to findings of fraud or abuse or even if the only findings of fraud or abuse are presented in or referred to from the section on internal control over financial reporting. (See paragraphs 4.37–.38.)

²⁹ *Government Auditing Standards* requires the auditor to communicate in writing to officials of the audited entity violations of provisions of contracts or grant agreements or abuse that is less than material but more than inconsequential. Paragraph 5.09 of *Government Auditing Standards* requires the reference illustrated in this paragraph if the auditor has issued a management letter reporting such matters. This reference does not preclude the auditor from including other discussions or recommendations in the management letter. See paragraphs 4.37–.38.

and [identify the legislative or regulatory body³⁰ and is not intended to be and should not be used by anyone other than these specified parties.³¹

[Signature]

[Date]³²

³⁰ For an audit in accordance with Circular A-133, this sentence should include a reference to federal awarding agencies and, if applicable, pass-through entities. See the further discussion in chapter 12 of this guide.

³¹ This paragraph conforms to AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1). See AU section 532 for additional guidance on restricted-use reports.

³² Because this report relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should carry the same date as the auditor's report on the financial statements.

Example 4-4

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters³³ Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (for a Governmental Entity and With Reference to Audits by Other Auditors Using the Reference Option)³⁴ (No Material Weaknesses [No Significant Deficiencies Identified], No Reportable Instances of Noncompliance or Other Matters)³⁵

[Addressee]

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of Example Entity as of and for the year ended June 30, 20X1, which collectively comprise Example Entity's basic financial statements and have issued our report thereon dated August 15, 20X1. Our report was modified to include a reference to other auditors.³⁶ We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,³⁷ issued by the Comptroller General of the United States. Other auditors audited the financial statements of [identify organization, function, or activity], as described in our report on Example Entity's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.^{38,39}

³³ See footnote 20.

³⁴ See paragraphs 4.43–45 for discussion of the reference option for acknowledging the involvement of other auditors in the report on internal control over financial reporting and compliance and other matters.

³⁵ The auditor should use the portions of this report and example 4-5 that apply to a specific addressee situation. For example, if the auditor has identified significant deficiencies but has not identified instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, the internal control section of example 4-5 would be used along with the compliance and other matters section of this report. Alternatively, if the auditor has not identified significant deficiencies but has identified instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, the internal control section of this report would be used along with the compliance section of example 4-5.

³⁶ Also describe any other departures from the standard report (for example, a qualified opinion or a modification as to consistency because of a change in accounting principle).

³⁷ See footnote 3.

³⁸ There may be circumstances in which none of the other auditors' audits referred to in the financial statement report were performed under *Government Auditing Standards*. In that situation, the last sentence in this paragraph should be replaced with the following:

The financial statements of [identify organization, function, or activity] were not audited in accordance with *Government Auditing Standards*.

See also paragraph 4.41 for additional guidance on modifying the scope paragraph when the financial statements include organizational units that are not required to have a *Government Auditing Standards* audit. Paragraph 4.40 provides guidance on similar modifications to the report on the financial statements.

³⁹ There may be circumstances in which some other auditors' audits were not performed under *Government Auditing Standards*, while some other auditors' audits were performed under those standards. In that situation, an additional sentence should be added to this paragraph as follows:

The financial statements of [identify organizations, functions, or activities] audited by other auditors that were not performed under *Government Auditing Standards* were not audited in accordance with *Government Auditing Standards*.

(continued)

Internal Control Over Financial Reporting^{40,41}

In planning and performing our audit, we considered Example Entity's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Example Entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters⁴²

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of Example Entity in a separate letter dated August 15, 20X1.⁴³

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity,

(footnote continued)

See also paragraph 4.41 for additional guidance on modifying the scope paragraph when the financial statements include organizational units that are not required to have a Government Auditing Standards audit. Paragraph 4.40 provides guidance on similar modifications to the report on the financial statements.

⁴⁰ See footnote 26.

⁴¹ See footnote 27.

⁴² See footnote 28.

⁴³ See footnote 29.

and *[identify the legislative or regulatory body]*⁴⁴ and is not intended to be and should not be used by anyone other than these specified parties.⁴⁵

[Signature]

*[Date]*⁴⁶

⁴⁴ See footnote 30.

⁴⁵ See footnote 31.

⁴⁶ See footnote 32.

Example 4-5**Report on Internal Control Over Financial Reporting and on Compliance and Other Matters⁴⁷ Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards (Significant Deficiencies, Reportable Instances of Noncompliance, and Other Matters Identified)*⁴⁸**

[Addressee]

We have audited the financial statements⁴⁹ of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1.⁵⁰ We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,⁵¹ issued by the Comptroller General of the United States.⁵²

Internal Control Over Financial Reporting^{53,54}

In planning and performing our audit, we considered Example Entity's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Example Entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying schedule of findings and responses⁵⁵ to be significant deficiencies in internal control over financial reporting. [List

⁴⁷ See footnote 20.

⁴⁸ See footnote 21.

⁴⁹ See footnote 22.

⁵⁰ See footnote 23.

⁵¹ See footnote 3.

⁵² See footnote 25.

⁵³ See footnote 26.

⁵⁴ See footnote 27.

⁵⁵ For an audit in accordance with Circular A-133, this reference should be to the schedule of findings and questioned costs.

the reference numbers of the related findings, for example, 20X1-1, 20X1-3, and 20X1-4].

[**NOTE:** As discussed in paragraph 4.34, this guide recommends identifying each finding with a reference number. As discussed in paragraph 4.30, this report can, as an alternative, describe findings and responses rather than refer to a separate schedule. Paragraph 4.30 also discusses how to report findings that relate to both internal control over financial reporting and to compliance; paragraph 4.31 discusses when findings of fraud and abuse should be reported in the section on internal control over financial reporting; paragraphs 4.32–.33 discuss the detail to use to present each finding; and paragraphs 4.35–.36 discuss the presentation of the views of responsible officials and their planned corrective actions. The schedule of findings and questioned costs shown in example 12-5 in appendix A in chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit" of this guide further describes the presentation of financial statement findings. Further, in an audit in accordance with Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, findings and responses should not be described in this report; instead, this report should refer to the schedule of findings and questioned costs. See the further discussion in chapter 12 of this guide.]

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses.⁵⁶ However, we believe that none of the significant deficiencies described above is a material weakness.

Compliance and Other Matters⁵⁷

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*⁵⁸ and which are described in

⁵⁶ If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that were identified by the auditor. The last sentence of this paragraph should be replaced with language such as the following:

"However, of the significant deficiencies described above, we consider items [list the reference numbers of the related findings, for example, 20X1-1 and 20X1-4] to be material weaknesses."

⁵⁷ See footnote 28.

⁵⁸ Paragraphs 4.16–.17 discuss the *Government Auditing Standards* criteria for reporting fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse. It is important to note within that discussion that in an audit conducted in accordance with Circular A-133, the

(continued)

the accompanying schedule of findings and responses as items [*list the reference numbers of the related findings, for example, 20X1-2 and 20X1-5*].

[**NOTE:** The referenced findings should include reportable: (a) instances of noncompliance; and (b) fraud or abuse that is not the result of a significant deficiency (See paragraphs 4.16 and 4.31). The "Note" in the internal control section of this example report further discusses the presentation of findings and auditee responses.]

We noted certain matters that we reported to management of Example Entity in a separate letter dated August 15, 20X1.⁵⁹

Example Entity's response to the findings identified in our audit are described in the accompanying schedule of findings and responses [*"or above" if findings and responses are included in the body of the report*]. We did not audit Example Entity's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, and [*identify the legislative or regulatory body*]⁶⁰ and is not intended to be and should not be used by anyone other than these specified parties.⁶¹

[*Signature*]

[*Date*]⁶²

(footnote continued)

auditor should apply a financial statement materiality consideration in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting. That is because those findings already are reported in the Circular A-133 report and reporting findings that are not material to the financial statements again in the *Government Auditing Standards* report would be unnecessarily duplicative.

⁵⁹ See footnote 29.

⁶⁰ See footnote 30.

⁶¹ See footnote 31.

⁶² See footnote 32.

Example 4-6

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters⁶³ Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (for a Governmental Entity and With Reference to Audits by Other Auditors Using the Inclusion Option)⁶⁴ (Significant Deficiencies, Reportable Instances of Noncompliance, and Other Matters Identified)⁶⁵

[Addressee]

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of Example Entity as of and for the year ended June 30, 20X1, which collectively comprise Example Entity's basic financial statements and have issued our report thereon dated August 15, 20X1. Our report was modified to include a reference to other auditors.⁶⁶ We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,⁶⁷ issued by the Comptroller General of the United States. Other auditors audited the financial statements of [identify organization, function, or activity], as described in our report on Example Entity's financial statements. This report includes our consideration of the results of the other auditor's testing of internal control over financial reporting and compliance and other matters that are reported on separately by those other auditors. However, this report, insofar as it relates to the results of the other auditors, is based solely on the reports of the other auditors.⁶⁸

Internal Control Over Financial Reporting^{69,70}

In planning and performing our audit, we considered Example Entity's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Example Entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over financial reporting.

⁶³ See footnote 20.

⁶⁴ See paragraphs 4.43–48 for discussion of the inclusion option for acknowledging the involvement of other auditors in the report on internal control over financial reporting and compliance and other matters.

⁶⁵ The auditor should use the portions of example 4-3 and this report that apply to a specific auditee situation. For example, if the auditor has identified significant deficiencies but has not identified instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, the internal control section of this report would be used along with the compliance and other matters section of example 4-3. Alternatively, if the auditor has not identified significant deficiencies but has identified instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, the internal control section of example 4-3 would be used along with the compliance section of this report. However, since example 4-3 does not assume other auditor involvement, similar wording to that noted in this report relating to other auditors would have to be incorporated.

⁶⁶ See footnote 36.

⁶⁷ See footnote 3.

⁶⁸ See footnote 39.

⁶⁹ See footnote 26.

⁷⁰ See footnote 27.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we and the other auditors identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying schedule of findings and responses⁷¹ to be significant deficiencies in internal control over financial reporting. [*List the reference numbers of the related findings, for example, 20X1-1, 20X1-3, and 20X1-4*].

[**NOTE:** As discussed in paragraph 4.34, this guide recommends identifying each finding with a reference number. As discussed in paragraph 4.30, this report can, as an alternative, describe findings and responses rather than refer to a separate schedule. Paragraph 4.30 also discusses how to report findings that relate to both internal control over financial reporting and to compliance; paragraph 4.31 discusses when findings of fraud and abuse should be reported in the section on internal control over financial reporting; paragraph 4.46 discusses considerations relating to including other auditors' results; paragraphs 4.32–.33 discuss the detail to use to present each finding; and paragraphs 4.35–.36 discuss the presentation of the views of responsible officials and their planned corrective actions. The schedule of findings and questioned costs shown in example 12-5 in appendix A in chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide further describes the presentation of financial statement findings. Further, in an audit in accordance with Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, findings and responses should not be described in this report; instead, this report should refer to the schedule of findings and questioned costs. See the further discussion in chapter 12 of this guide.]

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant

⁷¹ For an audit in accordance with Circular A-133, this reference should be to the schedule of findings and questioned costs.

deficiencies that are also considered to be material weaknesses.⁷² However, we believe that none of the significant deficiencies described above is a material weakness.

Compliance and Other Matters⁷³

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*⁷⁴ and which are described in the accompanying schedule of findings and responses as items [*list the reference numbers of the related findings, for example, 20X1-2 and 20X1-5*].

We also noted certain matters that we reported to management of Example Entity in a separate letter dated August 15, 20X1.⁷⁵

[**NOTE:** The referenced findings should be those that are instances of non-compliance. They also should be those that are fraud or abuse that are not significant deficiencies. (See paragraph 4.31.) The "Note" in the internal control section of this example report further discusses the presentation of findings and auditee responses.]

Example Entity's response to the findings identified in our audit are described in the accompanying schedule of findings and responses [*"or above" if findings and responses are included in the body of the report*]. We did not audit Example Entity's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, and [*identify the legislative or regulatory body*]⁷⁶ and is not intended to be and should not be used by anyone other than these specified parties.⁷⁷

[*Signature*]

[*Date*]⁷⁸

⁷² If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that were identified by the auditor. The last sentence of this paragraph should be replaced with language such as the following:

"However, of the significant deficiencies described above, we consider items [*list the reference numbers of the related findings, for example, 20X1-1 and 20X1-4*] to be material weaknesses."

⁷³ See footnote 28.

⁷⁴ See footnote 58.

⁷⁵ See footnote 29.

⁷⁶ See footnote 30.

⁷⁷ See footnote 31.

⁷⁸ See footnote 32.

Part II

Circular A-133 Audits

Chapter 5

Overview of the Single Audit Act, Circular A-133, and the Compliance Supplement

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (chapters 2–4 of this guide discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in Part I of this guide in addition to the guidance in Part II, "Circular A-133 Audits" (chapters 5–13).

Introduction

5.01 This chapter provides an overview of the significant requirements and guidance in the Single Audit Act Amendments of 1996 (the Single Audit Act); Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*;¹ and the *OMB Circular A-133 Compliance Supplement (Compliance Supplement)*. As discussed in paragraph 5.07, the Single Audit Act and Circular A-133 require nonfederal entities that expend \$500,000 or more of federal awards in a fiscal year to have a single or program-specific audit. Auditors should refer to the Single Audit Act, Circular A-133, and the *Compliance Supplement* for a complete understanding of the requirements. Appendixes A and B of this guide reprint the Single Audit Act and Circular A-133. Footnote 11 at paragraph 5.47 provides instructions for obtaining the *Compliance Supplement*.

5.02 The Single Audit Act was enacted to streamline and improve the effectiveness of audits of federal awards and to reduce the audit burden on states, local governments, and not-for-profit organizations (NPOs). Those goals were achieved, in part, by increasing the dollar threshold for requiring a single or program-specific audit and by introducing a risk-based approach for determining which federal programs are to be considered major programs. (Paragraph 5.07 discusses the audit threshold and paragraph 5.28 discusses the risk-based approach.) The Single Audit Act and Circular A-133 require auditors to perform single and program-specific audits of federal awards in accordance with *Government Auditing Standards*, which incorporates the fieldwork and reporting standards of GAAS and the related Statements on Auditing Standards (SASs)

¹ Because Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, incorporates the requirements of the Single Audit Act Amendments of 1996 (the Single Audit Act), the requirements of Circular A-133 and the act often are discussed together as one in this guide. Accordingly, references to Circular A-133 also include the requirements of the Single Audit Act.

issued by the AICPA unless the Comptroller General of the United States excludes them by formal announcement.² The Single Audit Act requires the audits to be conducted by an independent auditor.³ The Single Audit Act gives the Director of OMB the authority to develop government-wide guidelines and policy on performing audits to comply with the act. The OMB issued Circular A-133 to establish audit guidelines and policy for a uniform system of auditing states, local governments, and NPOs that expend federal awards.⁴ Individual federal departments and agencies have adopted Circular A-133 in regulation.

Single Audit Act and Circular A-133 Requirements

Objectives of a Single Audit

5.03 In a single audit, the auditor has the following objectives, each of which results in the issuance of certain auditor reports (as discussed in chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," and 13, "Program-Specific Audits," of this guide):

- Audit of the entity's financial statements and reporting on the schedule of expenditures of federal awards—
 - Determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. (Note that Circular A-133 does not prescribe the basis of accounting for financial statement preparation.) (See the further discussion in chapter 6, "Planning Considerations of Circular A-133," of this guide.)
 - Determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. (See also chapter 7, "Schedule of Expenditures of Federal Awards.")
- Compliance audit of federal awards—
 - Obtain an understanding of the internal control over compliance for each major program, assess the control risk, and perform tests of those controls unless the controls are deemed to be ineffective. (The auditor should perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for each major program.) (See also chapter 9, "Consideration of Internal Control Over Compliance for Major Programs.")

² To date, the Comptroller General has not excluded any fieldwork or reporting standards or related Statements on Auditing Standards (SASs).

³ The Single Audit Act Amendments of 1996 (the Single Audit Act) defines *independent auditor* as (a) an external state or local government auditor who meets the independence standards included in *Government Auditing Standards* or (b) a public accountant who meets such independence standards. Chapter 2, "Planning Considerations of *Government Auditing Standards*," of this guide discusses the independence requirements of *Government Auditing Standards*.

⁴ Circular A-133 was first revised and issued on June 30, 1997. That revision superseded OMB Circular A-128, *Audits of State and Local Governments*, and all previous versions of Circular A-133. The June 30, 1997, revision was subsequently revised by changes published in the *Federal Register* on June 27, 2003 and again by changes published in the *Federal Register* on June 26, 2007.

- Determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that may have a direct and material effect on each of its major programs (hereinafter referred to as *compliance requirements*). (See also chapter 10, "Compliance Auditing Applicable to Major Programs")

Audit of an Entity's Financial Statements and Reporting on the Schedule of Expenditures of Federal Awards

5.04 The financial statement audit required by Circular A-133 is performed in accordance with the standards applicable to financial audits contained in GAAS and *Government Auditing Standards*.⁵ That audit results in the auditor reporting on the entity's financial statements and on the scope of the auditor's testing of compliance and internal control over financial reporting and the results of those tests. The auditor also should report certain fraud and abuse. The primary sources of guidance and standards regarding financial statement audits are the AICPA SASs,⁶ particularly AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1); *Government Auditing Standards*; and the AICPA Audit and Accounting Guides, including *Health Care Organizations, Not-for-Profit Organizations, and State and Local Governments*. Chapter 6 of this guide discusses financial statement audit considerations under Circular A-133.

5.05 Circular A-133 also requires the auditor to determine and report on whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole. AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), and paragraph .07 of AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1) provide guidance on such reporting on the schedule of expenditures of federal awards. Chapter 7 of this guide discusses the schedule of expenditures of federal awards and chapter 12 of this guide discusses the auditor's reporting on the schedule.

Compliance Audit of Federal Awards

5.06 Under Circular A-133, the auditor has additional testing and reporting responsibilities for compliance, as well as internal control over compliance, beyond a financial statement audit performed in accordance with GAAS and *Government Auditing Standards*. The compliance audit of federal awards expanded during the fiscal year provides a basis for issuing an additional report on compliance and on internal control over compliance related to major programs. Table 5-1 presents the additional compliance testing and internal control requirements of the Single Audit Act and Circular A-133. Circular A-133 defines

⁵ In performing audits in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*, the auditor assumes certain responsibilities beyond those of audits performed in accordance with generally accepted auditing standards (GAAS). Chapters 2, 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," and 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide discuss those responsibilities.

⁶ SASs are codified in AICPA *Professional Standards*, volume 1. See the section in the preface titled "References to Professional Standards" for further explanation.

major programs; chapter 8, "Determination of Major Programs," of this guide discusses that definition. Chapters 9, "Consideration of Internal Control over Compliance for Major Programs," and 10, "Compliance Auditing Applicable to Major Programs," of this guide discuss auditing considerations applicable to compliance and internal control over compliance related to major programs.

Table 5-1

Additional Compliance Testing and Internal Control Responsibilities

| | <i>Fieldwork Responsibilities</i> | <i>Reporting Responsibilities</i> |
|-------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Compliance Testing Responsibilities | The auditor should determine whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that may have a direct and material effect on each major program. | The auditor should express an opinion on whether the entity complied with laws, regulations, and with the provisions of contracts or grant agreements which could have a direct and material effect on each major program and, where applicable, refer to a separate schedule of findings and questioned costs. |
| Internal Control Responsibilities | With regard to internal control over compliance, the auditor should (1) perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, (2) plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program, ¹ and (3) perform tests of internal control (unless the internal control is likely to be ineffective in preventing or detecting noncompliance). The auditor may use evidence gained from the tests of controls relevant to compliance requirements to determine the nature, timing, and extent of the testing required to express an opinion on compliance with requirements applicable to major programs. | The auditor should provide a written report on internal control over major programs describing the scope of testing internal control and the results of the tests, and, where applicable, refer to a separate schedule of findings and questioned costs. |

¹ Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, require the auditor to plan the audit to support a low assessed level of control risk for major programs; however, it does not actually require the auditor to achieve a low assessed level of control risk. Chapter 9, "Consideration of Internal Control Over Compliance for Major Programs," of this guide further discusses that Circular A-133 provision.

General Audit Requirements

Audit Threshold

5.07 Circular A-133 states that nonfederal entities that expend \$500,000 or more of federal awards (as discussed in paragraphs 5.08–.14) in a fiscal year should have a single or program-specific audit. Entities expending awards under only one program (excluding research and development [R&D]) may elect to have a program-specific audit if the program's laws, regulations, or grant agreements do not require a financial statement audit. A program-specific audit may not be elected for R&D unless (a) all expenditures are for awards received from the same federal agency or from the same federal agency and the same pass-through entity and (b) advance approval is obtained. (Chapter 13 provides additional guidance on program-specific audits.) Entities that expend less than \$500,000 in a fiscal year in federal awards are exempt from audit requirements in the Single Audit Act and Circular A-133. However, those entities are not exempt from other federal requirements (including those to maintain records) concerning federal awards provided to the entity. Further, section 200(d) of Circular A-133 states that records must be available for review or audit by appropriate officials of a federal agency, pass-through entity, and the U.S. Government Accountability Office (GAO). The Single Audit Act provides that, every two years, the OMB may review the amount for requiring audits and may adjust the dollar threshold amount to no less than \$300,000.

Types of Federal Awards and Payment Methods

Definition of Federal Awards

5.08 Circular A-133 defines federal awards as *federal financial assistance* and *federal cost-reimbursement contracts* that auditees receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts (under grants or contracts) used to buy goods or services from vendors. Paragraph 5.27 discusses subrecipient and vendor determinations.

Federal Financial Assistance—Classification and Types

5.09 Federal financial assistance is classified into program categories in the *Catalog of Federal Domestic Assistance* (CFDA), published by the Government Printing Office. (An electronic searchable version of the CFDA is available at www.cfda.gov.) Circular A-133 defines a federal program as all federal awards under the same CFDA number. Certain clusters of federal programs should be treated as one program when determining major programs. R&D, student financial aid (SFA), and certain other programs are defined as a cluster in the *Compliance Supplement* because they are closely related and share common compliance requirements. (Paragraphs 5.46–.47 discuss the *Compliance Supplement*.)

5.10 Sometimes state governments combine funding from different federal awards in providing assistance to their subrecipients when the awards are closely related programs and share common compliance requirements. In this case, Circular A-133 states that the state may require the subrecipient to treat the combined federal awards as a cluster of programs, as discussed in paragraph 5.30.

5.11 There are over 1,000 individual grant programs. Many of these programs are described in the CFDA; however, certain programs may not be

included. For example, contracts may not be listed in the CFDA. Circular A-133 states that when a CFDA number is not assigned, all federal awards from the same agency that are made for the same purpose should be combined and considered one program.

5.12 Programs in the CFDA are classified into 15 types of assistance. Benefits and services are provided through seven financial and eight nonfinancial types of assistance. The following list describes the eight principal types of assistance that are available.

- *Formula grants.* For activities of a continuing nature not confined to a specific project, allocations of money to nonfederal entities are made in accordance with a distribution formula prescribed by law or administrative regulation. One example is the Department of Agriculture's award to land-grant universities for cooperative extension services. Another example is the Department of Justice's award to state and local governments for drug control and systems improvement.
- *Project grants.* These involve the funding (for fixed or known periods) of specific projects. Project grants can include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, survey grants, and construction grants.
- *Direct payments for specific use.* Financial assistance is provided by the federal government directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance on a particular performance by the recipient. This does not include solicited contracts for the procurement of goods and services for the federal government.
- *Direct payments with unrestricted use.* Financial assistance is provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed on how the money is spent. Included are payments under retirement, pension, and compensation programs.
- *Direct loans.* Financial assistance is provided through the lending of federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- *Guaranteed/insured loans.* For these programs, the federal government makes an arrangement to indemnify a lender against part or all of any defaults by those responsible for the repayment of loans.
- *Insurance.* Financial assistance is provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through a private carrier, and may or may not involve the payment of premiums.
- *Sale, exchange, or donation of property and goods.* These programs provide for the sale, exchange, or donation of federal real property, personal property, commodities, and other goods, including land,

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

Federal Cost-Reimbursement Contracts

5.13 The definition of federal awards also includes federal cost-reimbursement contracts. These are contracts with nonfederal entities to provide goods or services to the federal government. These contracts generally are governed by the Federal Acquisition Regulations (found in part 41 of the *Code of Federal Regulations*) and the terms of the contracts.

Payment Methods

5.14 There are several distinct types of federal award payment methods. Awards may be provided to entities through reimbursement arrangements in which recipients bill grantors for costs as incurred. Some programs provide for advance payments. Other programs permit entities to draw cash as grant expenditures are incurred.

Defining the Entity to Be Audited

5.15 As discussed in chapter 6 of this guide, the Circular A-133 audit should cover the entire operations of the auditee or, at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards during the fiscal year, provided that each audit encompasses the financial statements and the schedule of expenditures of federal awards for each such department, agency, and organizational unit.

Relationship to Other Audit Requirements

5.16 A Circular A-133 audit is deemed to be in lieu of any financial audit of federal awards that an entity is required to undergo under any other federal law or regulation. However, notwithstanding a Circular A-133 audit, federal agencies (including their Inspectors General or GAO) may conduct or arrange for additional audits (for example, financial audits, performance audits, evaluations, inspections, or reviews) that are necessary to carry out their responsibilities under federal law or regulation. Any additional audits should be planned and performed in such a way as to build upon work performed by auditors. Circular A-133 requires a federal agency that conducts or contracts for additional audits to arrange for funding the full cost of such additional audits. Paragraph 5.31 discusses the federal agency option to request certain programs to be audited as major programs.

5.17 Circular A-133 states that the audit should be performed in accordance with *Government Auditing Standards*. Consequently, *Government Auditing Standards* applies not only to the audit of the financial statements but also to the compliance audit. Paragraph 1.22 of *Government Auditing Standards* defines a financial audit as including auditing compliance with regulations relating to federal award expenditures and other governmental financial assistance in conjunction with or as a byproduct of a financial statement audit. Therefore, auditors should ensure that they comply with the general, fieldwork, and reporting standards in chapters 3–5 of *Government Auditing Standards* in conducting the A-133 compliance audit. Those standards are discussed in chapter 2, "Planning Considerations of *Government Auditing Standards*," chapter 3, "Financial Statement Audit Considerations of GAS" and chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of

Government Auditing Standards," of this guide. Areas that may require particular attention in the compliance audit are auditor communication; audit documentation; procedures and reporting on abuse; the reporting of findings and related management views and planned corrective actions; and the reporting of certain matters in writing to officials of the audited entity. For example,

- Auditors should communicate information regarding the nature, timing, and extent of planned testing and reporting and the level of assurance under Circular A-133 to specified parties during the planning phase of the audit.
- Auditors have no responsibility to design the audit to detect abuse.⁷ However, if auditors become aware of indications of abuse that could be quantitatively or qualitatively material to the financial statements they should apply audit procedures specifically directed to ascertain the potential effect on the financial statements or other financial data significant to audit objectives. Chapter 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide discusses procedures relating to the evaluation of indications of abuse and chapters 9 and 10 of this guide discusses the nature of abuse as it relates to federal awards. Chapter 12 of this guide discusses the reporting of abuse involving federal awards.
- Auditors should obtain and report the views of responsible officials concerning findings, conclusions, and recommendations, as well as their planned corrective actions. As discussed in chapter 12 of this guide, the auditor may be able to refer to the auditee's corrective action plan required by Circular A-133 to satisfy that requirement for federal award-related findings. In addition, all audit findings, including federal award-related findings, are subject to the presentation requirements of *Government Auditing Standards*, as discussed in chapter 4 and 12 of this guide.
- Paragraph 5.16 of *Government Auditing Standards* states that the auditor should communicate to officials of the audited entity in writing violations of provisions of contracts or grant agreements or abuse that have an effect on the financial statements that is less than material but more than inconsequential. This communication may be done in a management letter. As discussed in chapter 12 of this guide, in an audit in accordance with Circular A-133, the auditor should evaluate such matters involving federal awards for the purpose of that communication based only on their consequence to the financial statements.

Frequency of Audits

5.18 Circular A-133 states that audits should be performed annually unless an auditee meets one of the following criteria that would allow it to have biennial audits (biennial audits should cover both years within the biennial period):

⁷ Paragraph 4.12 of *Government Auditing Standards* describes *abuse* by stating that it does not necessarily involve fraud, violations of laws, regulations, or provisions of a contract or grant agreement. Abuse, it states, "involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances."

- State or local governments that are required by constitution or statute (in effect on January 1, 1987) to undergo audits less frequently than annually are permitted to have Circular A-133 audits performed biennially. This requirement should still be in effect for the biennial period under audit.
- NPOs that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, are permitted to have Circular A-133 audits performed biennially.

Non-U.S.-Based Entities

5.19 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a sub-recipient. For example, if a federal agency provides financial assistance to an orphanage operated by a foreign government, Circular A-133 would not apply. However, the Circular does apply to expenditures made by U.S.-based entities outside of the United States and by foreign branches of U.S.-based entities. For example, if a university based in the United States receives a federal award for travel and a three-month residence in a foreign country to conduct research, Circular A-133 would apply to the travel and the related research costs incurred in the foreign country. Another example would be a hospital that receives a federal award to perform medical research in a foreign country. If the research is conducted in the hospital's research laboratory based in the foreign country, the federal award would be subject to an audit under Circular A-133.

Reporting Matters

Audit Reports

5.20 Section 505 of Circular A-133 includes specific auditor reporting requirements. It states that the auditor's reports should include (a) an opinion (or disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles and an opinion (or disclaimer of opinion) as to whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole, (b) a report on internal control related to the financial statements and major programs, (c) a report on compliance with laws, regulations, and the provisions of contracts or grant agreements, which includes an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on each major program, and (d) a schedule of findings and questioned costs.⁸ Chapters 12 and 13 of this guide discuss auditor reporting requirements for single and program-specific audits and include appendixes that illustrate schedules of findings and questioned costs and auditor's reports.

Timing of the Submission of the Report

5.21 The audit should be completed and the reporting package described in paragraph 5.37, including the auditor's reports, and the data collection form

⁸ Chapter 4 of this guide further discusses the auditor's reports under GAAS and *Government Auditing Standards* (that is, an opinion [or disclaimer of opinion] as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles and a report on internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements) and includes an appendix that illustrates those reports.

described in paragraph 5.38 should be submitted by the auditee to the Federal Audit Clearinghouse (FAC). That submission should be made within the earlier of 30 days after receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (Paragraphs 5.41–.44 discuss the definitions and responsibilities of cognizant and oversight agencies for audit.) Chapter 12 of this guide further describes the report submission requirements of Circular A-133.

Audit Follow-Up

5.22 Circular A-133 states that the auditor should follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report a current-year audit finding when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. Chapter 6 of this guide further discusses the auditor's responsibility for audit follow-up.

Auditor Selection and Audit Costs

Procurement of Audit Services and Restriction on Auditors Who Prepare Indirect Cost Proposals

5.23 Circular A-133 establishes guidance on the procurement of audit services, as well as guidance on the restrictions on the selection of auditors who also prepare the indirect cost proposal or cost allocation plan. As further discussed in chapter 6 of this guide, auditors who prepare the indirect cost proposal or cost allocation plan may not also be selected to perform the Circular A-133 audit if the indirect costs recovered by the auditee during the prior year exceeded \$1 million.

Audit Costs

5.24 Circular A-133 provides guidance on whether the charging of audit costs to federal awards may be allowed. Unless prohibited by law, the costs of Circular A-133 audits are allowable charges to federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB Cost Principles Circulars, the Federal Acquisition Regulation, or other applicable cost principles or regulations. The costs of audits that are not conducted in accordance with Circular A-133 are unallowable. Furthermore, audit costs associated with Circular A-133 audits of entities that expend less than \$500,000 per year in federal awards are unallowable. However, this provision does not prohibit pass-through entities from charging federal awards for the costs of limited-scope audits to monitor its subrecipients. Chapter 11, "Audit Considerations of Federal Pass-Through Awards," of this guide further discusses the allowability of audit costs associated with limited-scope audits. With regard to the amount of audit cost that can be charged to a federal award, the Single Audit Act states that in the absence of documentation demonstrating a higher actual cost, the percentage of the cost of single audits charged to federal awards by an entity may not exceed the ratio of total federal awards expended to the entity's total expenditures for the fiscal year.

Basis for Determining When Federal Awards Are Expended

5.25 The determination of when an award is expended is based on when the activity related to the award occurs. In general, the activity pertains to events that require the auditee to comply with laws, regulations, and the provisions of contracts or grant agreements. Such events include the following:

- Expenditure/expense transactions associated with grants, cost reimbursement contracts, cooperative agreements, and direct appropriations
- The disbursement of funds passed through to subrecipients
- The use of loan proceeds under loan and loan-guarantee programs
- The receipt of property, including surplus property
- The receipt or use of program income
- The distribution or consumption of food commodities
- The disbursement of amounts entitling the auditee to an interest subsidy
- The period when insurance is in force

5.26 As further discussed in chapter 7 of this guide, Circular A-133 provides specific guidance on the basis for determining federal awards expended or the valuation for the following noncash items:

- Loans and loan guarantees, including those at institutions of higher education
- Prior loans and loan guarantees
- Endowment funds
- Free rent
- Noncash assistance, such as free rent, food stamps, food commodities, and donated property, including donated surplus property

Circular A-133 does not consider Medicare payments made to a nonfederal entity for patient care services to individuals to be federal awards. It also does not consider a state's Medicaid payments to a nonfederal entity for such services to be federal awards for purposes of the patient care service provider's audit unless the state requires it because the payments are on a cost-reimbursement basis. However, Circular A-133 considers the Medicaid payments made by a state to patient care service providers to be federal awards for purposes of the state's audit and reporting.

Subrecipient and Vendor Determinations

5.27 An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient are subject to audit under Circular A-133. Section 210 of Circular A-133 states that payments that vendors receive from a federal program for goods and services are not considered to be federal awards to the vendors and therefore not subject to an A-133 audit. Circular A-133 provides specific guidance on determining whether payments constitute a federal award or a payment for goods and services. Chapter 11 of this guide further discusses that guidance.

Major Program Determination

Risk-Based Approach

5.28 Circular A-133 states that the auditor should use a risk-based approach to determine which federal programs are major programs, which affects the scope of the audit. Circular A-133 places the responsibility for identifying major programs on the auditor, and provides criteria for the auditor to use in applying a risk-based approach. The auditor's determination of the programs to audit is based on an overall evaluation of the risk of noncompliance occurring that could be material to the individual federal programs. In evaluating risk, the auditor considers, among other things, the current and prior audit experience with the auditee, oversight by the federal agencies and pass-through entities, and the inherent risk of the federal programs, using a specific process established in the circular. Chapter 8 of this guide discusses that risk-based approach and the determination of major programs.

Low-Risk Auditee

5.29 Circular A-133 contains certain criteria for considering an auditee to be a low-risk auditee. A low-risk auditee is eligible for reduced audit coverage. *Low-risk auditee* is a term defined in Circular A-133 for the purpose of applying the percentage-of-coverage rule in the risk-based approach. (Chapter 8 of this guide discusses the low-risk auditee criteria and the percentage-of-coverage rule.) The term *low-risk auditee* does not imply or require the auditor to assess audit risk or any of its components as low for an entity that meets the Circular A-133 definition of a low-risk auditee.

Cluster of Programs

5.30 Circular A-133 defines a cluster of programs as a grouping of closely related federal programs that share common compliance requirements. The types of clusters of programs are R&D, SFA, and other clusters. "Other clusters" are defined by the OMB in the *Compliance Supplement* or are designated as such by a state for the federal awards the state provides to its subrecipients that meet the definition of a cluster of programs. When a state designates federal awards as an "other cluster," it also should identify the federal awards included in the cluster and advise the subrecipients of the compliance requirements applicable to the cluster. A cluster of programs should be considered as one program for determining major programs and (with the exception of R&D) whether a program-specific audit may be elected.

Federal Agency Selection of Additional Major Programs

5.31 Section 215(c) of Circular A-133 permits a federal agency to request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days before the end of the fiscal year to be audited. After consultation with its auditor, the auditee should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if not, the estimated incremental cost. The federal agency should then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon the federal agency's request, and the federal agency agrees to pay the full incremental costs, then the auditee should have the program

audited as a major program. This approach also may be used by pass-through entities for a subrecipient.⁹

Auditee Responsibilities

Financial Statements and Schedule of Expenditures of Federal Awards

5.32 As discussed in chapter 6 of this guide, Circular A-133 states that auditees should prepare financial statements that reflect their financial position, the results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements should be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements also may include departments, agencies, and other organizational units that have separate audits in accordance with Circular A-133 and prepare separate financial statements. As discussed in chapter 7 of this guide, Circular A-133 also states that auditees should prepare a schedule of expenditures of federal awards for the period covered by the financial statements.

Summary Schedule of Prior Audit Findings

5.33 In accordance with Circular A-133, the auditee should prepare a summary schedule of prior audit findings. The schedule should report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It also should include audit findings reported in the prior audit's summary schedule of prior audit findings, except audit findings that have been corrected or are no longer valid. Chapter 12 of this guide further discusses that schedule.

Other Responsibilities

5.34 Circular A-133 establishes certain other responsibilities for auditees, including:

- Identifying in its accounts all federal awards received and expended and the federal programs under which they were received, including, as applicable, the CFDA title and number, the award number and year, the name of the federal agency, and the name of the pass-through entity
- Establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs
- Complying with laws, regulations, and the provisions of contracts or grant agreements related to each of its federal programs
- Ensuring that the audits required by Circular A-133 are properly performed and submitted when due

⁹ In addition, section 520(c)(2) of Circular A-133 permits a federal awarding agency to request that a type A program for certain recipients not be considered low-risk so that it would be audited as a major program. Further, section 525(c)(2) of Circular A-133 states that federal agencies, with the concurrence of the OMB, may identify federal programs that are higher risk. That identification is provided by the OMB in the *Compliance Supplement*. See the further discussion of those provisions and the definition of type A programs in chapter 8, "Determination of Major Programs," of this guide.

- Following up and taking corrective action on audit findings (including the preparation of the previously discussed summary schedule of prior audit findings and a corrective action plan as discussed in paragraph 5.36); this guide recommends that corrective action should be initiated within six months after the receipt of the audit report and proceed as rapidly as possible

Responsibility for Compliance at the Financial Statement Level and for Internal Control Over Financial Reporting

5.35 Although not specifically stated in Circular A-133, the auditee also is responsible for complying with the requirements of laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on the financial statements and for establishing and maintaining effective internal control over financial reporting. *Government Auditing Standards* (which is required to be followed in Circular A-133 audit). Appendix I section A1.08, provides supplemental guidance stating that management of the audited entity is responsible for complying with applicable laws and regulations and implementing systems designed to achieve compliance with applicable laws and regulations.

Corrective Action Plan

5.36 At the completion of the audit, the auditee should prepare a corrective action plan to address each audit finding included in the current year's auditor's reports. Chapter 12 of this guide further discusses the corrective action plan.

Reporting Package

5.37 The auditee should submit to the FAC a reporting package* that comprises the previously discussed financial statements and schedule of expenditures of federal awards, summary schedule of prior audit findings, auditor's reports, and corrective action plan. The auditee should submit the reporting package with the data collection form described in paragraph 5.38. Paragraph 5.21 and chapter 12 of this guide describe the report submission requirements of Circular A-133. Section 320(g) of Circular A-133 states "auditees shall keep one copy of the data collection form . . . and one copy of the reporting package . . . on file for three years from the date of submission" to the FAC. Furthermore, unless restricted by law or regulation, the auditee should make copies of the data collection form and the reporting package available for public inspection.

Data Collection Form

5.38 The auditee is required to complete and sign certain sections of a data collection form, stating whether the audit was completed in accordance with Circular A-133 and providing information about the auditee, its federal programs, and the results of the audit. The auditor also is required to complete and sign certain sections of the form. Chapter 12 of this guide further discusses the data collection form.

* The Federal Audit Clearinghouse (FAC) is expected to issue a revised Data Collection Form in or before August 30, 2008 that is to be used for audits completed in 2008 and later years. It is expected that as part of the issuance of the form, the FAC will begin to require that the complete submission be handled entirely electronically. (That is, the data collection form will be prepared, submitted, and signed electronically and one reporting package will be submitted electronically.) Please refer to the FAC Web site for more information. See also the information beginning at the section titled "Data Collection Form" in chapter 12.

Federal Awarding Agency Responsibilities

5.39 Circular A-133 establishes certain responsibilities for federal agencies that provide federal awards to recipients, including the following:

- Identifying the federal awards made by informing each recipient of the CFDA title and number, the award name and number, the award year, and if the award is for R&D. When some of this information is not available, the federal agency should provide information necessary to clearly describe the federal award.
- Advising recipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements.
- Ensuring that audits are completed and reports are received in a timely manner and in accordance with the requirements of Circular A-133.
- Providing technical advice and counsel to auditees and auditors as requested.
- Issuing a management decision on audit findings within six months after receipt of the audit report and ensuring that the recipient takes appropriate and timely corrective action.
- Assigning a person to provide annual updates of the *Compliance Supplement* to the OMB.

Pass-Through Entity Responsibilities

5.40 Pass-through entities have many responsibilities that are similar to those of federal awarding agencies. Chapter 11 of this guide describes the responsibilities of pass-through entities.

Cognizant Agency for Audit

Definition

5.41 Circular A-133 defines the cognizant agency for audit as a federal agency designated to carry out the federal responsibilities with regard to a single audit. For recipients expending more than \$50 million a year in federal awards, the cognizant agency for audit will be the federal awarding agency that provides the predominant amount of direct funding to the recipient unless the OMB makes a specific cognizant agency for audit assignment. The determination of the predominant amount of direct funding is based on the direct federal awards expended by a recipient during its fiscal year ending in 2004, 2009, 2014, and every fifth year thereafter.¹⁰ For example, audit cognizance for periods ending in 2006–2010 will be determined based on the federal awards expended in 2004. Audit cognizance can be reassigned if both the old and the new federal agencies notify the auditee (and, if known, the auditor) of the change within 30 days of the reassignment. A recipient may have one federal agency responsible for audit cognizance and another federal agency responsible for the negotiation of indirect costs.

¹⁰ A current listing of cognizant agency for audit assignments is available at the FAC Web site at <http://harvester.census.gov/sac/dissemin/reports.html>. Under the heading "Select Specialized Report," enter the option titled "Cognizant Agency Report."

Responsibilities

5.42 Circular A-133 states that a cognizant agency for audit is responsible for:

- Providing technical audit advice and liaison to auditees and auditors.
- Considering auditee requests for extensions to the report submission due date. The cognizant agency for audit may grant extensions for good cause.
- Obtaining or conducting quality control reviews of selected audits made by nonfederal auditors and providing the results, when appropriate, to other interested organizations.
- Promptly informing other affected federal agencies and appropriate federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by *Government Auditing Standards* or laws and regulations.
- Advising the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee should work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit should notify the auditor, the auditee, and the applicable federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repeated substandard performance by auditors will be referred to appropriate state licensing agencies and professional bodies for disciplinary action.
- Coordinating, to the extent practicable, the audits or reviews made by or for federal agencies that are in addition to audits under Circular A-133, so that the additional audits or reviews build upon the Circular A-133 audits performed.
- Coordinating a management decision for audit findings that affect the federal programs of more than one federal agency.
- Coordinating the audit work and reporting responsibilities among auditors, to achieve the most cost-effective audit.

For biennial audits, the cognizant agency for audit also is responsible for considering auditee requests to qualify as a low-risk auditee.

Oversight Agency for Audit

Definition

5.43 An auditee that does not have a designated cognizant agency for audit (that is, one that expends \$50 million or less in federal awards) will have an oversight agency for audit. Circular A-133 defines the oversight agency for audit as a federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit as previously discussed. When there is no direct funding, the federal agency with the predominant indirect funding should assume the oversight responsibilities. An oversight agency for audit may reassign oversight to another federal agency that provides substantial funding and agrees to be the oversight agency for

audit. Within thirty days after reassignment, both the old and the new oversight agency for audit should notify the auditee (and, if known, the auditor) of the reassignment.

Responsibilities

5.44 Circular A-133 describes the duties of oversight agencies for audit. The responsibilities of an oversight agency for audit are not as broad as those of a cognizant agency for audit. An oversight agency's primary responsibility is to provide technical advice to auditees and auditors when it is requested. However, an oversight agency may assume all or some of the responsibilities normally performed by a cognizant agency for audit.

Program-Specific Audits

5.45 Circular A-133 provides general guidance on performing program-specific audits. In many cases, a program-specific audit guide will be available from the federal agency's Office of Inspector General. The audit guide will provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. When a program-specific audit guide is not available, the auditee and auditor have basically the same responsibilities for the federal program as they would have for an audit of a major program in a single audit. Chapter 13 of this guide further discusses program-specific audits.

OMB Circular A-133 Compliance Supplement

5.46 Circular A-133 states that the auditor should determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements (compliance requirements) that may have a direct and material effect on each of its major programs. The principal tool for this purpose is the *Compliance Supplement*. Chapter 10 of this guide further discusses compliance requirements and the *Compliance Supplement*.

5.47 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. The *Compliance Supplement*, which is updated annually,¹¹ serves to identify existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Single Audit Act and Circular A-133.

- For the programs it includes, the *Compliance Supplement* provides a source of information for auditors to understand the federal program's objectives, procedures, and compliance requirements relevant to the audit, as well as the audit objectives and suggested audit procedures for determining compliance with these requirements.
- For programs not listed in the *Compliance Supplement*, the auditor should follow *Compliance Supplement* part 7, "Guidance for Auditing Programs Not Included in This Compliance Supplement," which instructs the auditor to use the types of compliance

¹¹ The *Compliance Supplement* is available on the OMB's Web site at www.whitehouse.gov/omb/grants/grants_circulars.html or for sale from the Government Printing Office by calling (202) 512-1800.

requirements (for example, cash management, reporting, allowable costs/cost principles, activities allowed or unallowed, eligibility, and matching, level of effort, and earmarking) contained in the *Compliance Supplement* as guidance for identifying the types of compliance requirements to test, and to determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

Chapter 6

Planning Considerations of Circular A-133

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (Chapters 2–4 of this guide), discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in part I of this guide in addition to the guidance in part II, "Circular A-133 Audits" (Chapters 5–13 of this guide).

Introduction

6.01 In planning an audit to meet the requirements of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the auditor needs to consider several matters in addition to those ordinarily associated with an audit of financial statements in accordance with generally accepted auditing standards (GAAS) and *Government Auditing Standards*. This chapter discusses additional planning considerations in a single audit conducted in accordance with Circular A-133. Many of these planning considerations also are applicable in program-specific audits, which are discussed in chapter 13, "Program-Specific Audits," of this guide.

6.02 Chapter 2, "Planning Considerations of *Government Auditing Standards*," of this guide discusses matters that are relevant to the planning of a financial statement audit. The rest of this chapter discusses the following additional or expanded matters relevant to the planning of a single audit:

- Satisfying Circular A-133 requirements
- Establishing an understanding with the auditee
- Audit documentation
- Additional requirements of the Single Audit Act Amendments of 1996 (the Single Audit Act) and Circular A-133 regarding audit documentation and audit follow-up
- Financial statement audit considerations
- Defining the entity to be audited
- Determining the audit period
- Initial-year audit considerations
- Timing of the completion of the audit and report submission deadlines
- Determining the major programs to be audited
- Audit risk considerations

- Assessing the risk of material noncompliance
- Audit materiality considerations
- Determining compliance requirements
- Developing an efficient audit approach
- Joint audits and reliance on others
- Existence of an internal audit function
- Communications with the cognizant or oversight agency for audit and others
- Understanding the applicable state and local compliance and reporting requirements
- Desk reviews and on-site reviews
- Restriction on the auditor's preparation of indirect cost proposals

Satisfying Circular A-133 Requirements

6.03 AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1), describes the auditor's responsibility when engaged to conduct an audit in accordance with Circular A-133. If the entity is seeking an audit in accordance with Circular A-133, the auditor should include a statement in a proposal, in a contract, or in the communication issued to establish an understanding with the auditee (see paragraph 6.04) that the engagement is intended to meet the requirements of Circular A-133. AU section 801 also describes the auditor's responsibilities, including communication responsibilities, when the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, such as Circular A-133. Chapter 1, "Introduction," of this guide further discusses the provisions of AU section 801, including the persons to whom such communication should be made, the documentation of the communication, and the effect of the entity's response to the auditor's communication on other aspects of the audit.

Establishing an Understanding With the Auditee

6.04 As discussed in chapter 2 of this guide, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), states that the auditor should establish an understanding with the auditee regarding the services to be performed for each engagement. That understanding generally contains the information found in paragraph .09 of AU section 311 and should be communicated in the form of an engagement letter. In addition to the matters communicated as part of the financial statement audit under generally accepted accounting principles, as discussed in chapter 2 of this guide, *Government Auditing Standards* states that the auditor should include information regarding the planned work and level of assurance related to internal control over financial reporting and compliance with laws, regulations, and provisions of grants and contracts. Therefore, because the Circular A-133 audit is performed under *Government Auditing Standards*, the communication should include the planned work and level of assurance related to internal control over compliance and compliance with laws, regulations, and provisions of grants and contracts necessary for an audit in accordance with Circular A-133. Examples of the type

of information that might be included in the communication when performing an audit in accordance with Circular A-133 are as follows:

- A statement that the supplemental schedule(s) to be considered in the audit include the schedule of expenditures of federal awards
- A statement that the auditing standards and requirements that will be followed include Circular A-133
- The objective of an audit in accordance with Circular A-133
- A description of the additional reports required by Circular A-133 that the auditor is expected to prepare and issue, including any limitation on their use
- A description of management's responsibility for (a) preparation of the schedule of expenditures of federal awards in accordance with Circular A-133 requirements; (b) internal control over compliance; (c) compliance with laws, regulations, and the provisions of contracts and grant agreements; (d) following up and taking corrective action on audit findings, including the preparation of a summary schedule of prior audit findings and a corrective action plan; and (e) submitting the reporting package and data collection form
- A statement that management will make the auditor aware of significant vendor relationships where the vendor is responsible for program compliance (so that the auditor can determine if additional procedures on vendor records will be necessary—see chapter 11, "Audit Considerations of Federal Pass-Through Awards," of this guide)
- A description of the auditor's responsibility in a compliance audit of major programs under Circular A-133, including the determination of major programs, the consideration of internal control over compliance, and reporting responsibilities
- A statement that the parties to whom audit documentation will be made available upon request include federal agencies and the U.S. Government Accountability Office (GAO)

Audit Documentation

6.05 Audit documentation guidance, as it relates to the beginning stages of an audit, is in AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol.1). As part of the fieldwork guidance of generally accepted auditing standards, this guidance is applicable to all audits performed under *Government Auditing Standards*, including audits in accordance with Circular A-133. Paragraph .123 of AU section 314 states that generally the more complex the entity and its environment, including its internal control, and the more extensive the audit procedures performed by the auditor, the more extensively the auditor should document his or her work. While the manner in which these matters are documented is determined using the auditor's professional judgment, AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance. Paragraph .03 of AU section 339 states that the auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures

performed), the audit evidence obtained and its source, and the conclusions reached. Audit documentation is important because it provides the principal support that the audit was performed in accordance with GAAS, *Government Auditing Standards* and Circular A-133, and provides the principal support for each of the opinions issued.

Additional Requirements of the Single Audit Act and Circular A-133 Regarding Audit Documentation and Audit Follow-Up¹

Audit Documentation Access and Retention

6.06 Based on language in the Single Audit Act, section 515(b) of Circular A-133 states that audit working papers (referred to in this guide as *audit documentation*) "shall be made available upon request to the cognizant or oversight agency for audit or its designee, a Federal agency providing direct or indirect funding, or GAO at the completion of the audit, as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities . . ." It also states that access to the audit documentation includes the right to obtain copies. The Senate Committee report that accompanied the Single Audit Act stated that federal agencies should be judicious in the exercise of this authority and that it was the Committee's intent that the federal agencies recognize that audit documentation may contain trade secrets and confidential commercial and financial information and should treat such information as confidential under the Freedom of Information Act (U.S. Code title 5, section 552). AU section 9339, *Audit Documentation: Auditing Interpretations of Section 339* (AICPA, *Professional Standards*, vol. 1), contains guidance for when a regulator requests access to audit documentation pursuant to law, regulation, or audit contract.

6.07 Circular A-133 states that auditors should retain audit documentation and reports for a minimum of three years after the date of issuance of the auditor's report to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. However, paragraph .32 of AU section 339 states that audit documentation should be retained for at least five years from the report release date. The AU section 339 documentation retention guidance should be followed for Circular A-133 audits because the five year retention period is longer than the three year period defined in Circular A-133. When the auditor is aware that the federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor should contact the parties contesting the audit finding for guidance before the destruction of the audit documentation and reports.

Audit Follow-Up

6.08 Circular A-133 states that the auditor should follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any

¹ Chapter 2, "Planning Considerations of *Government Auditing Standards*," of this guide discusses the *Government Auditing Standards* audit documentation access and follow-up requirements.

prior audit finding. Chapters 10, "Compliance Auditing Applicable to Major Programs," and 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide further discuss the auditor's responsibility for audit follow-up.

Financial Statement Audit Considerations

6.09 Circular A-133 states that auditees should prepare financial statements that reflect their financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements should be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements also may include departments, agencies, and other organizational units that have separate audits and prepare separate financial statements (see paragraph 6.12). Circular A-133 also states that auditees should prepare a schedule of expenditures of federal awards for the period covered by the financial statements. Chapter 7, "Schedule of Expenditures of Federal Awards," of this guide discusses the schedule of expenditures of federal awards.

6.10 Circular A-133 does not prescribe the basis of accounting that auditees should use to prepare their financial statements. However, auditees should disclose the basis of accounting and significant accounting policies used in preparing the financial statements. Circular A-133 states that auditees should be able to identify in their accounts all federal awards expended and the federal programs under which they were received. Generally, auditees evidence the ability to identify federal awards expended by preparing a reconciliation of amounts presented in the financial statements to the amounts and programs in the schedule of expenditures of federal awards.

6.11 Circular A-133 states that the auditor should issue an opinion (or a disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP).² (Chapters 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," and 12 of this guide provide guidance on reporting on the auditee's financial statements.) If the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP,³ the auditor still is required to

² As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government's basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. In addition, the auditor may provide opinions or disclaimers of opinion on additional opinion units if engaged to set the scope of the audit and assess materiality at a more detailed level than by the opinion units required for the basic financial statements. Throughout this guide, the use of the singular terms *opinion* and *disclaimer of opinion* encompasses the multiple opinions and disclaimers of opinion that generally will be provided on a government's financial statements.

³ Paragraph .04 of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), defines the comprehensive bases of accounting other than generally accepted accounting principles (GAAP), known as *other comprehensive bases of accounting* (OCBOA), and establishes requirements for reporting on audits of OCBOA financial statements. Auditing Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)," and No. 15 "Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request," of AU section 623 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .90–.98), provide additional guidance

(continued)

express or disclaim an opinion. AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), contains relevant requirements and guidance. The financial statements also should be audited in accordance with *Government Auditing Standards*. (See the note at the beginning of this chapter.) Circular A-133 does not impose on the financial statement audit any additional audit requirements beyond *Government Auditing Standards*.

Defining the Entity to Be Audited

6.12 One of the initial tasks during the planning process of a single audit is determining whether management has properly defined the entity to be audited. Circular A-133 states that single audits should cover the entire operations of the auditee. However, Circular A-133 provides auditees the option to meet the audit requirements of the circular through a series of audits that cover an auditee's departments, agencies, and other organizational units that expended or otherwise administered federal awards during a fiscal year. If an auditee elects this option, separate financial statements and a schedule of expenditures of federal awards should be prepared for each such department, agency, or other organizational unit. In these circumstances, an auditee's organization-wide financial statements also may include departments, agencies, or other organizational units that have separate audits and prepare separate financial statements. For example, if a local government has its school districts audited separately, it would be acceptable for the local government's financial statements to include the school districts, even though the school districts were not included in the local government's Circular A-133 audit, because a separate Circular A-133 audit was conducted on the school districts. However, if separate financial statements were not prepared for the school districts, it would be unacceptable for a separate Circular A-133 audit to be conducted on the school districts (that is, the local government's organization-wide financial statements could not be used as a substitute for separate financial statements for the school districts). Chapter 12 of this guide discusses auditor reporting in situations in which (a) the implementation regulations of federal awarding agencies⁴ define the entity to be audited differently than does GAAP and (b) the audit of federal awards does not encompass the entirety of the auditee's operations expending federal awards.

Determining the Audit Period

Fiscal Year and Program Period May Differ

6.13 An audit performed in accordance with Circular A-133 should cover the auditee's financial transactions (including transactions related to federal awards) for its fiscal year (or a two-year period, if allowed by Circular A-133),

(footnote continued)

on reporting on audits of OCBOA financial statements. The AICPA Audit and Accounting Guide *State and Local Governments* discusses the application of AU section 623 and those two interpretations to state and local governmental financial statements. That guide and paragraph .97 of Auditing Interpretation No. 15 also provide illustrative auditor's reports on OCBOA financial statements. In addition, in the AICPA's Practice Aid Series, two publications—*Applying OCBOA in State and Local Governmental Financial Statements* and *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*—provide nonauthoritative guidance on preparing and reporting on OCBOA financial statements.

⁴ Certain federal agencies, such as the U.S. Department of Housing and Urban Development, have specifically defined the level of the entity subject to audit.

which is not necessarily the same as the period of the program being funded. (Chapter 5, "Overview of the Single Audit Act, Circular A-133, and the *Compliance Supplement*," of this guide discusses the allowability of biennial audits). Thus, the audit might include only a part of the transactions of a federal award, because some transactions may not occur within the period covered by the audit.

Stub Periods

6.14 Stub periods may occur when an auditee converts from a program-specific audit to a single audit or changes audit periods. One example would be a community college with a September 30 year end that previously had a program-specific audit and is now converting to a single audit. The prior program-specific audits were performed based on a June 30 award year. The first single audit will be for the year ending September 30. This would leave the community college with an unaudited stub period of June 30 to September 30. The audit requirements of Circular A-133 still apply to federal expenditures during the stub period and are generally met through a separate audit of the stub period or by including expenditures of the stub period with the following period's Circular A-133 audit. Either way, the threshold for audit requirement is still \$500,000 in federal expenditures for the period. Auditees or their auditors can contact the cognizant or oversight agency for audit or the pass-through entity for advice on how stub periods can be addressed.

Initial-Year Audit Considerations

Preceding Period Audited by Another Auditor

6.15 Whenever an auditor is considering accepting an engagement in which the federal awards of the preceding period were audited by another auditor, the guidance in AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1), contains relevant information. It provides guidance on communications between predecessor and successor auditors when a change in auditors is in process or has taken place, and it includes illustrative letters. AU section 315 also provides communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor.

Factors to Consider Under the Risk-Based Approach

6.16 When the engagement includes the selection of major programs using the risk-based approach, an auditor accepting, or contemplating accepting, an engagement might consider gathering information about the following:

- Federal awards expended by federal programs
- Prior-period findings and questioned costs (including the corrective action plan and management decision related to the findings and summary schedule of prior audit findings)
- Whether a predecessor auditor used the exception that allows deviation from the risk-based approach during the last three years, as discussed in chapter 8, "Determination of Major Programs," of this guide
- Correspondence from program officials indicating potential problems
- New programs
- Changes to programs

- Amount of funding passed through to subrecipients by individual federal programs
- Extent to which computer processing is used to administer federal programs
- Federal programs audited as major programs for the last two years

Timing of the Completion of the Audit and Report Submission Deadlines

6.17 When planning the timing of the audit, auditors should consider the Circular A-133 requirement that the audit be completed and the data collection form and reporting package be submitted to the federal clearinghouse within a certain time period. Chapters 5 and 12 of this guide discuss the reporting package and the timing requirements for submission.

Determining the Major Programs to Be Audited

6.18 As discussed in chapter 5 of this guide, Circular A-133 states that the auditor should use a risk-based approach to determine which federal programs are major programs. This determination will affect the scope of the audit and the compliance requirements to be tested. Chapter 8 of this guide discusses the determination of major programs and an exception available for certain first year audits that allows deviation from the use of risk criteria in determining major programs.

Audit Risk Considerations

6.19 The auditor's consideration of audit risk and materiality when planning and performing a single audit is similar to the consideration in a financial statement audit in accordance with AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1). Audit risk and materiality, among other matters, need to be considered together for each major program being tested as well as for each direct and material compliance requirement in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

Preliminary Assessment of Audit Risk

6.20 As discussed in chapter 2 of this guide, in a financial statement audit, GAAS and *Government Auditing Standards* require the auditor to design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with laws, regulations, and provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts.⁵

⁵ Paragraph 4.28 of *Government Auditing Standards* and paragraph .02 of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), define the term *illegal acts* as violations of laws and regulations. As indicated in chapter 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide, it generally has been interpreted under generally accepted auditing standards that the term *laws and regulations* in AU section 317 implicitly includes provisions of contracts or grant agreements. This guide sometimes collectively refers to laws, regulations, and provisions of contracts and grant agreements as *compliance requirements* and to illegal acts and violations of provisions of contracts or grant agreements as *noncompliance* or *instances of noncompliance*.

6.21 Furthermore, Circular A-133 states that the auditor should determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. Therefore, in developing an audit plan for a Circular A-133 audit, the auditor should assess not only the risk that noncompliance may cause the financial statements to contain a material misstatement, but also the risk that noncompliance may have a material effect on each major program.

Components of Audit Risk

6.22 Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion. It is composed of inherent risk, control risk, fraud risk, and detection risk. For the purposes of a single audit and the auditor's opinion on compliance, these components are defined as follows:

- *Inherent risk*—The susceptibility of a major program's compliance requirements to material noncompliance, assuming there are no related controls.
- *Control risk*—The risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the entity's internal control.
- *Fraud risk*—The risk that intentional material noncompliance with a major program's compliance requirements could occur.
- *Detection risk*—The risk that the auditor will not detect noncompliance that could be material. It is a function of the effectiveness of the audit procedures and their application by the auditor.

Paragraphs 6.23–.26 discuss each of these components of audit risk and explain how the components of audit risk interrelate in providing a basis for the auditor's opinion on compliance.

Inherent Risk

6.23 In assessing inherent risk, factors that may be relevant to compliance engagements are the following:

- The complexity of the compliance requirements
- The length of time the entity has been subject to the compliance requirements
- Prior experience with the entity's compliance
- The potential effect of noncompliance, both qualitatively and quantitatively

Control Risk

6.24 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. The circular does not, however, actually require the auditor to achieve a low assessed level of control risk. The assessment of control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major program. The process of assessing control risk (together with assessing inherent risk and fraud risk) provides audit evidence about the risk that material noncompliance may exist. The auditor uses this audit evidence as part of the reasonable basis for his or her opinion on compliance. Chapter 9,

"Consideration of Internal Control Over Compliance for Major Programs," of this guide discusses the auditor's consideration of internal control over compliance for major programs, including the assessment of control risk.

Fraud Risk

6.25 As part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor should consider that assessment in designing the audit procedures to be performed. As discussed in chapter 3 of this guide, AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance to the auditor on his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud. Although AU section 316 applies only to an audit of financial statements (that is, its requirements do not apply to a compliance audit), the auditor may want to consider its guidance when planning and performing an audit of an auditee's compliance with specified requirements applicable to its major programs. Additionally, auditors may wish to refer to the AICPA Practice Aid titled *Fraud Detection in a GAAS Audit—Revised Edition*, which identifies example risk factors that relate to recipients of federal awards. When the auditor has assessed fraud risk and has deemed that a further response is necessary, the guidance in paragraphs .46–.67 of AU section 316 may be helpful.

Detection Risk

6.26 In determining an acceptable level of detection risk, the auditor considers his or her assessments of inherent risk, control risk, and fraud risk, and the extent to which he or she seeks to restrict the audit risk related to the major program. As assessed inherent risk, control risk, or fraud risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the compliance tests performed based on the assessments of inherent risk, control risk, and fraud risk. Circular A-133 requires compliance testing to include tests of transactions and such other auditing procedures necessary to provide the auditor with sufficient evidence to support an opinion on compliance. Such compliance testing serves to limit detection risk.

Assessing the Risk of Material Noncompliance

6.27 As part of the audit of the financial statements, members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatement as part of the risk assessment process. Similarly, the auditor may hold a discussion of the susceptibility of the entity's major programs to material noncompliance with compliance requirements in the planning meeting of the financial statement audit. This discussion may also be held separately from the general planning meeting if the planning of the single audit is done at a later date.

6.28 In assessing the risk of material noncompliance, the auditor should

- identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks.

- relate the identified risks to what can go wrong at the relevant compliance level.
- consider whether the risks are of a magnitude that could result in noncompliance with requirements that have a direct and material effect on one or more of the entity's major programs.
- consider the likelihood that the risks could result in noncompliance with requirements that have a direct and material effect on one or more of the entity's major programs.

Audit Materiality Considerations

Materiality Differences Between the Financial Statement Audit and the Single Audit

6.29 In auditing compliance with requirements governing major programs in accordance with Circular A-133, the auditor's consideration of materiality differs from that in an audit of financial statements in accordance with GAAS and *Government Auditing Standards*. In an audit of financial statements, materiality is considered in relation to the financial statements being audited.⁶ In designing audit tests and developing an opinion on an auditee's compliance with requirements having a direct and material effect on each major program, however, the auditor considers materiality in relation to each major program. Chapter 10 of this guide further discusses materiality considerations in a Circular A-133 audit.

Materiality for Purposes of Reporting Audit Findings

6.30 Circular A-133 requires the auditor to consider a lower level of materiality for purposes of reporting audit findings in the schedule of findings and questioned costs than for other purposes. The Circular A-133 "audit finding" materiality is different (and generally lower) than (a) the materiality used for planning and performing the single audit, (b) the materiality used for planning, performing, evaluating the results of, and reporting on the financial statement audit, or (c) expressing an opinion on the auditee's compliance with requirements having a direct and material effect on each major program.

6.31 Among other findings to be reported, Circular A-133 states that the auditor should report in the schedule of findings and questioned costs material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. (Chapter 12 of this guide describes other findings that Circular A-133 requires to be reported.) The auditor's determination of whether an instance of noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement (for example, activities allowed or unallowed, cash management, eligibility, or reporting) for a major program or an audit objective identified in the *OMB Circular A-133 Compliance Supplement (Compliance Supplement)*.

6.32 If, for example, when the auditor discovers one or more instances of noncompliance involving the reporting compliance requirement for a particular

⁶ Because an audit of a government's financial statements under the provisions of the AICPA Audit and Accounting Guide *State and Local Governments* is based on opinion units (see footnote 2), auditors make separate materiality determinations for purposes of planning, performing, evaluating the results of, and reporting for each opinion unit.

major program, several materiality determinations should be made using professional judgment. First, the auditor should decide whether the noncompliance is material to the reporting compliance requirement for the particular major program. If the auditor determines the noncompliance is material to the reporting type of compliance requirement, the noncompliance would be reported as a finding in the schedule of findings and questioned costs. Second, the auditor should decide whether the discovered noncompliance is material, either individually or when aggregated with other noncompliance findings, in relation to the particular major program taken as a whole. If the auditor determines the noncompliance is material to the major program taken as a whole, the auditor would express a qualified or adverse opinion on compliance with respect to the particular major program.⁷

Determining Compliance Requirements

6.33 Chapter 2 of this guide discusses how in planning the financial statement audit, the auditor should obtain from management the principal compliance requirements at the start of the audit. For the compliance audit, the auditee and auditor also may ascertain the principal compliance requirements for the largest federal programs by referring to the *Compliance Supplement*. For programs not included in the *Compliance Supplement*, auditors should refer to Part 7 of that document, which provides guidance for auditing programs not included in the *Compliance Supplement*. Among other things, Part 7 instructs auditors to review the federal award document and referenced laws and regulations applicable to the program, the *Catalog of Federal Domestic Assistance*, and previously issued compliance supplements. Chapter 10 of this guide further discusses the use of the *Compliance Supplement* to identify compliance requirements.

Developing an Efficient Audit Approach

6.34 Consideration of ways to achieve maximum audit efficiency may be useful in the planning stage of the audit. Examples of ways to achieve audit efficiency follow:

⁷ As discussed in chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide, paragraph 5.16 of *Government Auditing Standards* states that the auditor should communicate to the auditee in writing the following matters unless they are inconsequential—immaterial violations of provisions of contracts or grant agreements, and immaterial abuse. This communication may be done in a management letter. As discussed in chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide, in an audit in accordance with Circular A-133, the auditor should evaluate such matters involving federal awards for the purpose of that communication based only on their consequence to the financial statements. Further, it is not necessary for the auditor to communicate such findings in the written communication required by *Government Auditing Standards* if they are otherwise reported as audit findings in accordance with Circular A-133. Assume, for example, that during the Circular A-133 compliance audit, the auditor identifies a single \$1,000 instance of noncompliance with a contractual provision for a major program. The auditor determines that the likely questioned costs are less than \$10,000 for the type of compliance requirement, the noncompliance is not material in relation to a type of compliance requirement or an audit objective identified in the *OMB Circular A-133 Compliance Supplement*, and the noncompliance is not indicative of a significant deficiency. Therefore, Circular A-133 does not require the reporting of this instance of noncompliance as a federal audit finding. However, the auditor should evaluate the noncompliance in relation to the financial statements. If it is material to the financial statements, the auditor should report it as a financial statement finding in the schedule of findings and questioned costs. If it is less than material but more than inconsequential to the financial statements, the auditor should communicate it to the auditee in writing as required by *Government Auditing Standards*.

- The financial statement audit and the compliance audit could be planned at the same time.
- If the auditee's internal control for a compliance requirement is common to more than one major program, the transactions of those programs could be combined into one population for selecting sample sizes for internal control tests.
- Because Circular A-133 requires the planning and performance of internal control work to assess control risk as low (unless weaknesses are found), the auditor could take advantage of the low assessed level of control risk when he or she performs the substantive testing of compliance.
- Helpful quality control materials (such as planning checklists and reporting checklists) could be used.

Joint Audits and Reliance on Others

6.35 Circular A-133 encourages auditees, whenever possible, to make positive efforts to use small business, minority-owned firms, and women's business enterprises. In keeping with the spirit of that provision, certain auditees may engage such independent accounting firms on a joint-venture or subcontract basis. In these instances it may be necessary to refer to the work of other auditors. Chapter 2 of this guide discusses planning considerations for a joint audit.

6.36 A common occurrence, particularly in the governmental environment, is the separation of a single audit between the principal auditor of the reporting entity and a secondary auditor of a component organization included in the financial statements of the reporting entity (see paragraph 6.12). The principal auditor's report on the financial statements of the reporting entity most often refers to the report of the secondary auditor as it relates to the financial statements of the component organization (see chapter 4 for additional reporting considerations relating to other auditors). The principal auditor also may need to refer to the programs audited by other auditors in the auditor's reports on the schedule of expenditures of federal awards and on compliance with requirements applicable to each major program and on the internal control over compliance as they relate to federal awards administered by the component organization. In such cases, AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1), contains requirements and guidance. The AICPA Audit and Accounting Guide *State and Local Governments* also illustrates an auditor's report on the financial statements that refers to the work of another auditor in the paragraph reporting on supplementary information other than required supplementary information (known as SI), such as the schedule of expenditures of federal awards.

Existence of an Internal Audit Function

6.37 Chapter 2 of this guide discusses planning considerations when the auditee has an internal audit function and the internal auditors are involved in monitoring compliance with specified requirements. Internal auditors may monitor not only compliance requirements that affect the financial statement audit, but also those that affect major programs.

Communications With the Cognizant or Oversight Agency for Audit and Others

6.38 Chapter 2 of this guide discusses how the auditor may communicate with grantor agencies and other entities in planning the audit, the need to document that communication, and the types of topics that might be discussed. In a single audit, the auditor also may communicate with the cognizant agency for audit or the oversight agency for audit. If a planning meeting is held with that agency, the following single audit matters also may be discussed:

- The scope of the compliance testing of federal programs
- The intended use of the *Compliance Supplement*
- The identification of federal awards, including those that are considered to be major programs
- The form and content of the supplemental schedule of expenditures of federal awards
- The testing of the monitoring of subrecipients
- The scope of the review and testing of internal control over compliance
- The testing of compliance requirements
- The status of prior-year findings and questioned costs
- Federal agency or pass-through entity management decisions on prior-year findings
- Compliance requirements and any changes to those requirements

Understanding the Applicable State and Local Compliance and Reporting Requirements

Impact on Circular A-133 Audit

6.39 Auditors may be engaged to test and report on compliance with state and local laws and regulations in addition to testing and reporting on the compliance requirements as provided by *Government Auditing Standards* and Circular A-133. For example, there may be state-imposed requirements on state funds provided to political subdivisions or not-for-profit organizations (in this example, the state is not a pass-through entity). Even though such nonfederal awards are not considered part of the total federal awards expended by the auditee and are not subject to audit in accordance with Circular A-133, auditors would still need to consider such laws and regulations under GAAS and *Government Auditing Standards*. Therefore, in connection with the financial statement audit, auditors should obtain an understanding of applicable state and local compliance and reporting requirements that have a direct and material effect on the financial statements being audited. Chapter 3 of this guide discusses possible audit procedures to assess the completeness of management's identification of compliance requirements in connection with the financial statement audit.

Compliance Audits of State or Local Grants

6.40 When engaged to audit one or more grants subject to state or local compliance requirements, the auditor might consider performing the following

procedures in order to gather the needed information regarding compliance requirements:

- Determine whether the state or local government has a compliance supplement or other audit guide for the program.
- Inquire of management about the additional compliance auditing requirements applicable to the entity.
- Inquire of the audit divisions of the sponsoring agencies about the audit requirements applicable to the entity.
- Obtain any applicable audit guidance from the grantor agency (including any audit guides, amendments, administrative rulings, and so forth) pertaining to the grant.
- Read the grant agreements and any amendments, including referenced laws and regulations.
- Review information about governmental audit requirements that is available from state societies of CPAs or associations of governments.
- When appropriate, discuss with the grantor agency the scope of the testing that is expected to be performed.

Compliance Audits Not Involving Governmental Assistance

6.41 AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1), provides guidance for engagements related to an entity's compliance with (or management's written assertion about compliance with) specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance.

Desk Reviews and On-Site Reviews

6.42 In addition to the quality control requirements set forth in *Government Auditing Standards* as discussed in chapter 2 of this guide, cognizant agencies for audit have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews (note that the oversight agencies for audit also may perform these reviews).⁸ As a part of the cognizant agencies' evaluation of the completed reports of such engagements, and, as required by Circular A-133, the supporting audit documentation should be made available upon request by the representative of the federal agency. Audit documentation typically is reviewed at a location agreed upon by the cognizant agency for audit and the independent auditor. (Paragraph 6.06 and chapter 2 of this guide further discuss access to audit documentation.)

6.43 Whenever a review of the audit report or audit documentation discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are identified and the representative of the cognizant agency for audit determines that the audit report and the audit documentation are substandard, cognizant agencies may take further steps. In those instances

⁸ Among the tools that the cognizant and oversight agencies for audit use to perform desk reviews are two checklists from the President's Council on Integrity and Efficiency: the *Guide for Initial Review of A-133 Audit Reports* and the *Guide for Quality Control Review for A-133 Audits*. Copies of these guides are on the Internet at www.ignet.gov/pande/audit/psingle.html.

in which the audit is determined to be substandard by the federal agency, the matter may be submitted to state boards of public accountancy.

Restriction on the Auditor's Preparation of Indirect Cost Proposals

6.44 Circular A-133 precludes the auditor who prepares the indirect cost proposal or cost allocation plan from performing the single audit when indirect costs recovered by the auditee during the prior year exceeded \$1 million.⁹ This restriction applies to the base year used in the preparation of the indirect proposal or cost allocation plan and to any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. For example, an auditor who prepares an indirect cost proposal or cost allocation plan that is used as the basis for charging indirect costs in the fiscal year ending June 30, 20X1, is not permitted to perform the 20X1 single audit (assuming that the indirect costs recovered during the prior year exceeded \$1 million).

⁹ Paragraph 3.28d of *Government Auditing Standards* addresses the effect that the preparation of an entity's indirect cost proposal or cost allocation plan has on an auditor's independence. *Government Auditing Standards* allows the auditor to prepare the indirect cost proposal or cost allocation plan provided the amounts are not material to the financial statements, management assumes responsibility for all significant assumptions and data, and supplemental safeguards are implemented. (Chapter 2 of this guide discusses the independence requirements of *Government Auditing Standards*.) However, even if the auditor's preparation of an indirect cost proposal or cost allocation plan does not impair the auditor's independence, OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, continues to prohibit an auditor who prepared that proposal or plan from performing the Circular A-133 audit when indirect costs recovered by the entity during the prior year exceeded \$1 million.

Chapter 7

Schedule of Expenditures of Federal Awards

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (chapters 2–4 of this guide), discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in part I of this guide in addition to the guidance in part II, "Circular A-133 Audits" (chapters 5–13 of this guide).

Overview of Schedule Requirements

7.01 Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, states that the auditor should determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), and paragraph .07 of AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), provide guidance on such reporting. The schedule of expenditures of federal awards, prepared by the auditee, reports the total expenditures for each federal program and serves as the primary basis for the auditor's major program determination. (See chapter 5, "Overview of the Single Audit Act, Circular A-133, and the *Compliance Supplement*," of this guide for the Circular A-133 definition of federal programs). This chapter describes the federal agency, pass-through entity, and auditee requirements relating to the identification of federal awards, the auditor's requirements related to the schedule, and the general presentation requirements governing the schedule, pass-through awards, noncash awards, and endowment funds. Chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide discusses the auditor's reporting on the schedule.

Identification of Federal Awards

Federal Agency and Pass-Through Entity Requirements

7.02 According to Circular A-133, federal awarding agencies and pass-through entities have certain responsibilities related to the federal awards they make. Each recipient or subrecipient should be informed of the *Catalog of Federal Domestic Assistance* (CFDA) title and number, the award's name and number, the award year, and whether the award is for research and development

(R&D). When some of this information is not available, the federal agency or pass-through entity should provide the information necessary to describe the federal award clearly.

Auditee Requirements

7.03 Circular A-133 states that the auditee should identify in its accounts all federal awards received and expended, as well as the federal programs under which they were received. Federal program and award identification includes, as applicable, the CFDA title and number, the award number and year, the name of the federal granting agency, and the name of the pass-through entity.

Auditor Requirements Related to the Schedule of Expenditures of Federal Awards

Issuing an "In Relation To" Opinion

7.04 Circular A-133 states that the auditor should determine and provide an opinion on whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. Accordingly, the auditor need not apply procedures as extensive as would be necessary to express an opinion on the schedule of expenditures of federal awards itself. Paragraphs .04–.07 of AU section 550 provide guidance on the auditor's consideration of supplementary information, including auditor responsibilities and related procedures. It provides that the auditor should read the supplementary information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. AU section 551 provides guidance on the form and content of the reporting when the auditor expresses an "in relation to" opinion. If the audit of the basic financial statements does not encompass the financial information in the schedule, the auditor should modify or redirect procedures to support the "in relation to" opinion required by Circular A-133.

Additional Auditor Requirements Relating to Compliance Audit Objectives

7.05 The schedule of expenditures of federal awards is unlike certain other supplementary information included in documents containing audited financial statements in that it serves as the primary basis for the auditor's major program determination which is an important aspect of performing a single audit. Circular A-133 places the responsibility of preparing the schedule and including certain elements (as described in paragraph 7.10) on the auditee. However, Circular A-133 places the responsibility for determination of major programs on the auditor and the schedule of expenditures of federal awards provides the basis for making that determination. (See chapter 8, "Determination of Major Programs" of this guide.) Therefore, appropriate major program determination by the auditor is dependent on the accuracy and completeness of the information that makes up the schedule of expenditures of federal awards.

7.06 Chapter 9, "Consideration of Internal Control Over Compliance for Major Programs" of this guide further discusses the auditor's responsibility for considering internal control over compliance, including obtaining an understanding of the five components of internal control over compliance sufficient to assess the risks of material noncompliance. This understanding, coupled with

the auditor's understanding of internal control over financial reporting required for the financial statement audit, should include the auditee's controls over the accuracy and completeness of the expenditure amounts reported on the schedule, as well as controls over the accuracy of the CFDA numbers. Procedures may include inquiring of entity personnel, observing the application of specific controls, and inspecting documents and reports used in the preparation of the schedule. The understanding obtained should be sufficient for the auditor to assess the risks of material misstatement of the schedule of expenditures of federal awards and to design the nature, timing, and extent of further compliance audit procedures to test the accuracy and completeness of the schedule.¹

7.07 Further compliance audit procedures should be performed to obtain sufficient and appropriate audit evidence supporting the accuracy and completeness of the schedule of expenditures of federal awards, including the identification of federal programs in the schedule. In testing accuracy and completeness of the schedule of expenditures of federal awards, the auditor may use evidence obtained from audit procedures performed during the audit of the financial statements regarding the accuracy, completeness and classification of recorded revenues and expenditures. Additionally, the auditor may consider reviewing an auditee prepared reconciliation of amounts reported in the schedule and the notes to the schedule to corresponding amounts reported in the financial statements or other underlying records used to prepare the schedule (for example, the general ledger, reimbursement requests, loan agreements, or other supporting documentation). The auditor may also consider sending confirmations to granting federal agencies or pass-through entities in an audit of a subrecipient. Finally, since Circular A-133 requires the auditee to include certain elements in the schedule, the procedures should also include a review of the auditee's schedule for the required elements set forth in Circular A-133 and described in paragraph 7.10.

7.08 When the auditor identifies control weaknesses pertaining to the auditee's preparation of a complete and accurate schedule, the auditor must evaluate identified control deficiencies and determine whether such deficiencies, individually or in combination, are significant deficiencies or material weaknesses relating to internal control over financial reporting, internal control over compliance, or both. Chapter 3, "Financial Statement Audit Considerations of GAS" and chapter 9 of this guide include a discussion of internal control and provide guidance to assist auditors in making an assessment of internal control deficiencies. If a control deficiency is determined to be a significant deficiency or material weakness, the auditor should report a finding in the schedule of findings and questioned costs. Chapter 12 of this guide further discusses the reporting of findings and the schedule of findings and questioned costs.

General Presentation Requirements

Basis of Accounting

7.09 Circular A-133 does not specifically prescribe the basis of accounting to be used by the auditee to prepare the schedule of expenditures of federal awards, although it does state that the determination of when an award is expended should be based on when the activity related to the award occurs

¹ The auditor's risk assessment may also be used in deciding what additional procedures, if any, should be performed in order to render an "in relation to" opinion (see paragraph 7.04).

and provides the guidance shown in table 7-1. (Circular A-133 also specifies the values that should be presented for certain types of awards; see table 7-2 at paragraph 7.19). Some schedules or some awards in schedules may be presented on a basis of accounting that differs from that used in the financial statements. In any case, the auditee should disclose the basis of accounting and the significant accounting policies used in preparing the schedule. As noted in paragraph 7.03, the auditee should also be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

Table 7-1**Basis for Determining When Federal Awards Are Expended**

| <i>Federal Awards</i> | <i>Basis for Determining When Expended</i> |
|-----------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------|
| Grants, cost reimbursement contracts, cooperative agreements, and direct appropriations | When the expenditure or expense transactions occur |
| Amounts passed through to subrecipients | When the disbursement is made to the subrecipient |
| Loan and loan guarantees | When the loan proceeds are used (See the further discussion on loans and loan guarantees in table 7-2 and paragraph 7.20.) |
| Donated property, including donated surplus property | When the property is received |
| Food commodities | When the food commodities are distributed or consumed |
| Interest subsidies | When amounts are disbursed entitling the entity to the subsidy |
| Insurance | When the insurance is in force |
| Endowments | When federally restricted amounts are held |
| Program income | When received or used |

Required Schedule Contents

7.10 Circular A-133 states that the auditee should prepare a schedule of expenditures of federal awards for the period covered by the auditee's financial statements. At a minimum, the schedule should:

- List individual federal programs by federal agency. For federal programs included in a cluster of programs, list individual federal programs within a cluster of programs. (Chapter 5 of this guide discusses clusters of programs.) For R&D, the total federal awards expended should be shown either by individual award or by federal agency and major subdivision within the federal agency. For example, the National Institutes of Health is a major subdivision

in the Department of Health and Human Services (the federal agency).

- For federal awards received as a subrecipient, include the name of the pass-through entity and the identifying number assigned by the pass-through entity.
- Provide the total federal awards expended for each individual federal program and the CFDA number or other identifying number when the CFDA information is not available.
- Include notes that describe the significant accounting policies used in preparing the schedule.
- For federal awards received as a pass-through entity, identify, to the extent practical, the total amount provided to subrecipients from each federal program. (Chapter 11, "Audit Considerations of Federal Pass-Through Awards," of this guide further discusses the audit considerations of federal pass-through awards.)
- Include, in either the schedule or a note to the schedule, the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end (see paragraph 7.20 and table 7-2).

Appendix A (paragraph 7.22) presents example schedules of expenditures of federal awards.

Providing Additional Information

7.11 Although not required, the auditee may choose to provide other information (in addition to the foregoing requirements) that is requested by federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a federal program has multiple award years, the auditee may choose to list the amount of federal awards expended for each award year separately, if so requested by a federal agency.

Schedule May Not Agree With Other Federal Award Reporting

7.12 The information included in the schedule of expenditures of federal awards may not fully agree with other federal award reports that the auditee submits directly to federal granting agencies because, among other reasons, the award reports (a) may be prepared for a different fiscal period and (b) may include cumulative (from prior years) data rather than data for the current year only.

Inclusion of Nonfederal Awards

7.13 Circular A-133 does not require nonfederal awards (for example, state awards) to be presented in the schedule. However, to meet state or other requirements, auditees may decide to include such awards in the schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

Considerations Relating to State Awards

7.14 Several state governments have auditing and reporting requirements for state awards that are similar to those for federal awards under Circular A-133. In these states, auditors may be engaged to test and report on compliance with the state compliance requirements as provided in the state award(s) and under applicable state laws or regulation. Some states require a separate compliance audit with a separate schedule of expenditures of state awards. However, others accept a combined schedule of federal and state awards along with additional testing of the state expenditures. If state (or other nonfederal) awards are included in the schedule of expenditures of federal awards, for clarity purposes, a best practice is for the auditee to clearly designate the nonfederal data and to modify the title of the schedule to indicate that nonfederal awards are included.

CFDA Number Not Available

7.15 The auditee may be unable to obtain the CFDA number, which is sometimes the case for new federal programs and R&D programs. In addition, cost-type contracts normally will not have a CFDA number. When the CFDA number is not available, the auditee has alternatives for presenting that information. The auditee could indicate that the CFDA number is not available and include, if available, another identifying number, such as a contract or grant number. The auditee also could apply the guidance presented in the Federal Audit Clearinghouse's data collection form instructions for when a federal program does not have a CFDA number. Specifically, if the program has a contract or grant number, the number shown as the CFDA number could be the awarding agency's two digit prefix listed for the agency in an appendix to the form's instructions (or 99 if the agency is not listed) followed by the contract or grant number. If the program does not have a contract or grant number, the number shown as the CFDA number could be the awarding agency's two digit prefix (or 99) followed by "UNKNOWN."

Pass-Through Awards

Treatment of Pass-Through Awards

7.16 Circular A-133 defines a subrecipient as an entity that expends federal awards that are received from a pass-through entity to carry out a federal program. State or local government redistributions of federal awards to subrecipients, known as "pass-through awards," should be treated by the subrecipient as though they were received directly from the federal government. That is, pass-through awards should be included in the scope of the single audit on the same basis as that of federal awards that are received directly. Chapter 11 of this guide further discusses the audit considerations of federal pass-through awards. As noted in paragraph 7.10, in addition to the other general presentation requirements, Circular A-133 states that the schedule should include the name of the pass-through entity and the identifying number assigned by the pass-through entity for federal awards received as a subrecipient.

Commingled Assistance

7.17 The individual sources (that is, federal, state, and local) of federal awards may not be separately identifiable because of commingled assistance

from different levels of government. If the commingled portion cannot be separated to specifically identify the individual funding sources, the total amount should be included in the schedule, with a note to the schedule describing the commingled nature of the funds.

Noncash Awards

Treatment of Noncash Awards

7.18 Most federal awards are in the form of cash awards. However, there are a number of federal programs that do not involve cash transactions. These programs may include loans and loan guarantees (including interest subsidies), insurance, endowments, free rent, food stamps, food commodities, and donated property (including donated surplus property). Circular A-133 states that the value of federal awards expended in the form of noncash assistance should be reported either on the face of the schedule or disclosed in the notes to the schedule. However, Circular A-133 also states that although it is not required, it is preferable to present this information in the schedule rather than in the notes to the schedule. Paragraph 7.09 and chapter 5 of this guide discuss the determination of when awards, including noncash awards, are considered to be expended.

Determining the Value of the Noncash Awards Expended

7.19 Table 7-2 shows the bases generally used to determine the value of noncash awards expended. (See section 205 of Circular A-133 for additional details.)

Table 7-2

Determining the Value of Noncash Awards Expended

| <i>Types of Noncash Awards</i> | <i>Basis Used to Determine the Value of Noncash Awards Expended</i> |
|-----------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Loans and loan guarantees (loans), including interest subsidies | Value equals amount of new loans made or received during the fiscal year plus the balance of loans from previous years for which the federal government imposes continuing compliance requirements (see paragraph 7.20), plus any interest subsidy, cash, or administrative cost allowance received. The proceeds of loans that were received and expended in prior years are not considered federal awards expended when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans. |

(continued)

| <i>Types of Noncash Awards</i> | <i>Basis Used to Determine the Value of Noncash Awards Expended</i> |
|------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Loans at institutions of higher education | Value the same as for loans above, except that when loans are made to students but the institution of higher education does not make the loans, the value equals only the amount of new loans made during the year. The balance of loans for previous years is not considered federal awards expended because the lender accounts for the prior balances. |
| Insurance | Value equals the fair value of the insurance contract at the time of receipt, or the assessed value provided by the federal agency. |
| Endowments | Value equals the cumulative balances of federally restricted amounts. |
| Free rent | Value equals the fair value at the time of receipt, or the assessed value provided by the federal agency. Free rent is not considered an award expended unless it is received as part of an award to carry out a federal program. |
| Food stamps, food commodities, and donated property (including donated surplus property) | Value equals the fair value at the time of receipt, or the assessed value provided by the federal agency. |

Loan and Loan Guarantee Continuing Compliance Requirements

7.20 As noted previously, in determining the value of total noncash awards expended for loans and loan guarantees, auditees should include the balances of loans from previous years in the schedule if the federal government imposes continuing compliance requirements. Circular A-133 does not specifically define the term *continuing compliance requirements*, although some federal agencies indicate that their loans have continuing compliance requirements, such as the U.S. Department of Housing and Urban Development (HUD) with regard to their insured, direct and HUD-held loans. Auditors should use professional judgment in evaluating the auditee's determination of whether continuing compliance requirements are significant enough to require inclusion of prior-year loan or loan guarantee balances. For example, if in a prior year an auditee expended the proceeds of a federal loan to construct a building, and the current-year activity consists only of loan repayments and a requirement by the federal lender for the auditee to submit a report that details only loan payment information, it may not be necessary to include the prior year's loan balance in determining the total amount of loans expended. However, if the federal lender requires the auditee to ensure on an ongoing basis that a certain percentage of the building is rented to low-income residents, it would likely be necessary to include the prior year's loan balance in determining the total amount of loans expended. If there is any question about an auditee's determination of whether

continuing compliance requirements are significant enough to require inclusion of the balances of prior loans or loan guarantees, the auditor might consider contacting the federal agency's Office of Inspector General for assistance.

Documentation Requirements

7.21 The audit procedures performed on the schedule of expenditures of federal awards supports the basis for the auditor's major program determination, as well as the auditor's "in relation to" opinion on the schedule. The audit work performed on the schedule to support these engagement objectives should be documented in accordance with AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol.1). Documenting the audit work performed on the schedule in an audit program is an effective way to record the audit procedures performed, relevant audit evidence obtained, conclusions reached and significant findings relating to the schedule, if any.

7.22

Appendix A—Illustrative Schedules of Expenditures of Federal Awards

Example Entity Schedule of Expenditures of Federal Awards¹ For the Year Ended June 30, 20X1

| <i>Federal Grantor/Pass-Through Grantor/Program or Cluster Title</i> | <i>Federal CFDA Number²</i> | <i>Pass-Through Entity Identifying Number³</i> | <i>Federal Expenditures⁴</i> |
|--------------------------------------------------------------------------------------------------------------------------|----------------------------------------|-----------------------------------------------------------|-----------------------------------------|
| U.S. Department of Agriculture: Summer Food Service Program for Children—Commodities | 10.559 | | \$ 46,000 |
| <i>Total U.S. Department of Agriculture</i> | | | \$ 46,000 |
| U.S. Department of Housing and Urban Development: Community Development Block Grant—Entitlement Grants (note 2) | 14.218 | | \$1,235,632 |
| Section 8 Housing Choice Vouchers | 14.871 | | <u>800,534</u> |
| <i>Total U.S. Department of Housing and Urban Development</i> | | | \$2,036,166 |
| U.S. Department of Education: Impact Aid | 84.041 | | \$ 372,555 |
| Literacy Through School Libraries | 84.364 | | <u>28,655</u> |
| Subtotal Direct Programs | | | \$ 401,210 |
| Pass-Through Program From: State Department of Education—Title I Grants to Local Educational Agencies | 84.010 | 23-8345-7612 | <u>\$1,239,398</u> |
| <i>Total U.S. Department of Education</i> | | | <u>\$1,640,608</u> |
| <i>Total Expenditures of Federal Awards</i> | | | <u><u>\$3,722,774</u></u> |

The accompanying notes are an integral part of this schedule.

¹ To meet state or other requirements, auditees may decide to include certain nonfederal awards (for example, state awards) in this schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule also should be modified to indicate that nonfederal awards are included. See paragraphs 7.13–.14.

² When the *Catalog of Federal Domestic Assistance* number is not available, the auditee has alternatives for presenting that information. See paragraph 7.15.

³ When awards are received as a subrecipient, the schedule should include the identifying number assigned by the pass-through entity.

⁴ Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* states that the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end should be included in either the schedule or a note to the schedule. Although it is not required, Circular A-133 states that it is preferable to present this information in the schedule (versus the notes to the schedule). If the auditee presents noncash assistance in the notes to the schedule, such amounts should be included in Part III of the data collection form.

Example Entity
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 20X1

Note 1. Basis of Presentation⁵

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity and is presented on the [*identify basis of accounting*]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

Note 2. Subrecipients⁶

Of the federal expenditures presented in the schedule, Example Entity provided federal awards to subrecipients as follows:

| <i>Program Title</i> | <i>Federal CFDA Number</i> | <i>Amount Provided to Subrecipients</i> |
|------------------------------------------------------|----------------------------|-----------------------------------------|
| Community Development Block Grant—Entitlement Grants | 14.218 | \$423,965 |

⁵ This note is included to meet the Circular A-133 requirement that the schedule include notes that describe the significant accounting policies used in preparing the schedule.

⁶ Circular A-133 states that the schedule of expenditures of federal awards should include, to the extent practical, an identification of the total amount provided to subrecipients from each federal program. Although this example includes the required subrecipient information in the notes to the schedule, the information may be included on the face of the schedule as a separate column or section, if the auditee prefers.

Example Entity University
Schedule of Expenditures of Federal Awards⁷
For the Year Ended June 30, 20X1

| <i>Federal Grantor/Pass-Through Grantor/Program or Cluster Title</i> | <i>Federal CFDA Number⁸</i> | <i>Pass-Through Entity Identifying Number⁹</i> | <i>Federal Expenditures¹⁰</i> |
|----------------------------------------------------------------------|----------------------------------------|-----------------------------------------------------------|------------------------------------------|
| <i>Student Financial Aid—Cluster:</i> | | | |
| U.S. Department of Education: ¹¹ | | | |
| Federal Pell Grant Program | 84.063 | | \$ 4,757,853 |
| Federal Family Education Loan Program | 84.032 | | 2,143,587 |
| Federal Direct Loan Program | 84.268 | | 1,863,506 |
| Federal Supplemental Educational Opportunity Grant | 84.007 | | 974,873 |
| Federal Work-Study Program | 84.033 | | 575,417 |
| Federal Perkins Loan Program (note 2) | 84.038 | | <u>1,548,343</u> |
| <i>Total U.S. Department of Education</i> | | | \$11,863,579 |
| U.S. Department of Health and Human Services: | | | |
| Nursing Student Loans (note 2) | 93.364 | | <u>\$ 823,582</u> |
| <i>Total U.S. Department of Health and Human Services</i> | | | \$ 823,582 |
| <i>Total Student Financial Aid</i> | | | \$12,687,161 |
| <i>Research and Development—Cluster:¹²</i> | | | |
| U.S. Department of Defense: | | | |
| Department of Army | 12.UNKNOWN | | \$ 87,403 |
| Office of Naval Research | 12.CT-123 | | <u>73,107</u> |
| Subtotal Direct Programs | | | \$ 160,510 |
| Pass-Through Programs From: | | | |
| XYZ Labs—Effects of Ice on Radar Images | 12.XYZ-65 | 4532 | <u>\$ 11,987</u> |
| <i>Total U.S. Department of Defense</i> | | | \$ 172,497 |
| National Science Foundation: | | | |
| National Science Foundation (note 3) | 47.UNKNOWN | | \$ 432,111 |

(continued)

⁷ See footnote 1.⁸ See footnote 2.⁹ See footnote 3.¹⁰ See footnote 4.

¹¹ Institutions of higher education often participate in certain loan and loan guarantee programs (for example, the Federal Family Education Loan Program and the Federal Direct Loan Program), as shown here. Circular A-133 states that when loans are made to students but the institution of higher education does not make the loans, the value of the loans made during the year is considered federal awards expended. Those loans and loan guarantees should be reported either on the face of the schedule or disclosed in the notes to the schedule, as discussed in paragraph 7.20.

¹² For research and development, Circular A-133 states that total the federal awards expended should be shown either by individual award or by federal agency and major subdivision within the federal agency. This example illustrates the federal agency and major subdivision option.

| <i>Federal Grantor/Pass-Through Grantor/Program or Cluster Title</i> | <i>Federal CFDA Number</i> | <i>Pass-Through Entity Identifying Number</i> | <i>Federal Expenditures</i> |
|--------------------------------------------------------------------------|----------------------------|-----------------------------------------------|-----------------------------|
| Pass-Through Programs From: | | | |
| ABC University—Atmospheric Effects of Volcano Eruptions | 47.ABC-852 | Abc97-8 | \$ 25,987 |
| <i>Total National Science Foundation</i> | | | \$ 458,098 |
| U.S. Department of Health and Human Services: | | | |
| National Institutes of Health Administration on Aging (note 3) | 93.MF-369 93.UNKNOWN | | \$ 675,321 |
| Subtotal Direct Programs | | | \$ 910,308 |
| Pass-Through Programs From: | | | |
| ABC Hospital—Heart Research State Health Department—Food Safety Research | 93.ABC-321 93.ST-789 | 5489-5 SG673-45 | \$ 432,765 |
| Subtotal Pass-Through Programs | | | \$ 556,752 |
| <i>Total U.S. Department of Health and Human Services</i> | | | \$ 1,467,060 |
| <i>Total Research and Development Other Programs:</i> | | | \$ 2,097,655 |
| U.S. Department of State: | | | |
| Educational Exchange—University Lectures and Research | 19.401 | | \$ 17,823 |
| <i>Total U.S. Department of State</i> | | | \$ 17,823 |
| U.S. Department of Education: | | | |
| TRIO Talent Search | 84.044 | | \$ 308,465 |
| Safe and Drug-Free Schools and Communities | 84.184 | | \$ 59,723 |
| Subtotal Direct Programs | | | \$ 368,188 |
| Pass-Through Programs From: | | | |
| State Department of Education—Vocational Education Basic Grant | 84.048 | 874-90-5473 | \$ 3,115 |
| State Department of Education—Tech-Prep Education | 84.243 | 25-8594-2167 | \$ 176,885 |
| Subtotal Pass-Through Programs | | | \$ 180,000 |
| <i>Total U.S. Department of Education</i> | | | \$ 548,188 |
| <i>Total Other Programs</i> | | | \$ 566,011 |
| <i>Total Expenditures of Federal Awards</i> | | | <u>\$15,350,827</u> |

The accompanying notes are an integral part of this schedule.

Example Entity University
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 20X1

Note 1. Basis of Presentation¹³

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity University and is presented on the [*identify basis of accounting*]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

Note 2. Loans Outstanding¹⁴

Example Entity University had the following loan balances outstanding at June 30, 20X1. Loans made during the year are included in the federal expenditures presented in the schedule.

| <i>Cluster / Program Title</i> | <i>Federal CFDA Number</i> | <i>Amount Outstanding</i> |
|-----------------------------------------------------|--------------------------------|-------------------------------|
| Student Financial Aid: Federal Perkins Loan Program | 84.038 | \$6,341,180 |
| Nursing Student Loans | 93.364 | \$ 3,815,635 |

Note 3. Subrecipients¹⁵

Of the federal expenditures presented in the schedule, Example Entity University provided federal awards to subrecipients as follows:

| <i>Program Title</i> | <i>Federal CFDA Number</i> | <i>Amount Provided to Subrecipients</i> |
|-----------------------------|--------------------------------|---------------------------------------------|
| National Science Foundation | 47.UNKNOWN | \$236,403 |
| Administration on Aging | 93.UNKNOWN | \$138,095 |

¹³ See footnote 5.

¹⁴ This note is intended to meet the Circular A-133 requirement that loans or loan guarantees outstanding at year end be included in the schedule. See paragraph 7.20.

¹⁵ See footnote 6.

Chapter 8

Determination of Major Programs

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (Chapters 2–4 of this guide), discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in part I of this guide in addition to the guidance in part II, "Circular A-133 Audits" (Chapters 5–13 of this guide).

Introduction

8.01 Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, states that the auditee should identify in its accounts all federal awards received and expended and the federal programs under which they were received. The auditee should also prepare a schedule of expenditures of federal awards for the period covered by its financial statements. (Chapter 7, "Schedule of Expenditures of Federal Awards," of this guide discusses the requirements related to that schedule.) However, Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides the criteria to be used in applying a risk-based approach to determining major programs. The risk-based approach is designed to focus the single audit on higher-risk programs. Paragraph 8.23 discusses when the auditor can deviate from the use of risk criteria.

8.02 The auditor's determination of the programs to be audited is based on an evaluation of the risk of noncompliance occurring that could be material to an individual major federal program. In evaluating such risk, the auditor considers, among other things, the current and prior audit experience with the auditee, the oversight exercised by federal agencies and pass-through entities, and the inherent risk of the federal programs. The auditor should use professional judgment and the guidance in sections 520, 525, and 530 of Circular A-133 in the risk assessment process. In addition, the auditor should consider the need to discuss the nature of federal programs with the management of the auditee and the federal or state agency that provided the funds to the auditee.

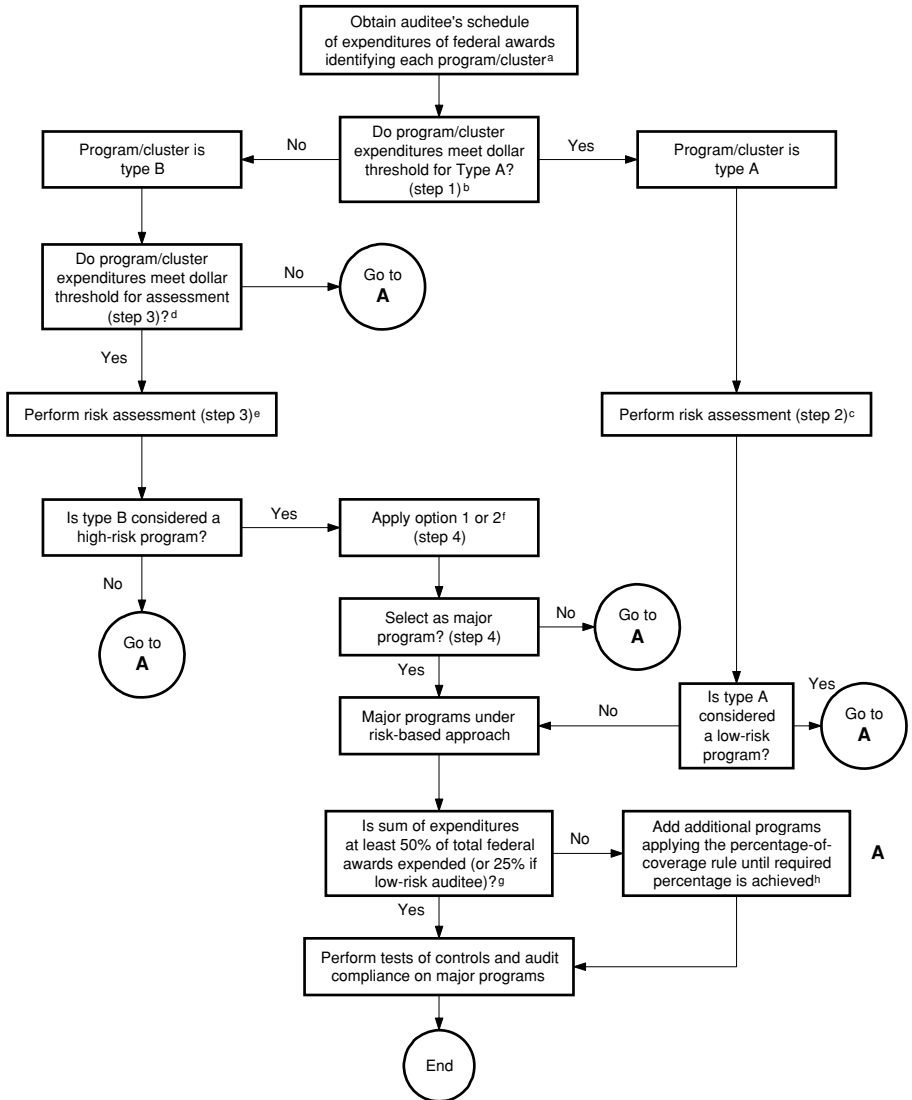
Applying the Risk-Based Approach

8.03 The guidance on the risk-based approach is organized here as provided in Circular A-133 and consists of the following steps in the following listing. Exhibit 8-1 is a flowchart illustrating the application of the risk-based approach for determining major programs.

- Step 1—Determination of type A and type B programs (paragraphs 8.04–.09)
- Step 2—Identification of low-risk type A programs (paragraphs 8.10–.13)
- Step 3—Identification of high-risk type B programs (paragraphs 8.14–.16)
- Step 4—Determination of programs to be audited as major (paragraphs 8.17–.19)

Exhibit 8-1

Flowchart Illustration of Applying the Risk-Based Approach for Determining Major Programs



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- ^a Chapter 5, "Overview of the Single Audit Act, Circular A-133, and the *Compliance Supplement*," of this guide defines federal programs, including clusters.
- ^b Paragraphs 8.04–.09 discuss step 1.
- ^c Paragraphs 8.10–.13 discuss step 2.
- ^d Paragraphs 8.14–.16 discuss step 3.
- ^e Before performing the risk assessment, this guide recommends the auditor consider whether option 1 or option 2 will be selected under step 4 because it will affect whether risk assessments need to be performed on all type B programs or only some type B programs. See paragraph 8.15.
- ^f The number of type B high-risk programs identified as major programs is either:
- *Option 1*: One-half of the number of type B high-risk programs, unless this number exceeds the number of low-risk type A programs identified in step 2. In this case, the auditor would be required to audit as major the same number of high-risk type B programs as low-risk type A programs. Under this option, the auditor is expected to perform risk assessments on all type B programs that exceed the threshold for type B.
 - *Option 2*: One high-risk type B program for each low-risk type A program. This option does not require the auditor to perform risk assessments on all type B programs. Paragraphs 8.17–.19 discuss step 4, including option 1 and option 2.
- ^g There may be instances when the auditee includes certain noncash assistance (such as loan guarantees or loans) in the notes to the schedule of expenditures of federal awards. (See chapter 7 of this guide.) The auditor should be sure to include such noncash assistance as part of total federal awards expended when performing this calculation.
- ^h The additional programs/clusters selected (marked "A" on the flowchart) to meet the percentage-of-coverage rule are audited as major programs in addition to type A and type B programs identified in steps 1–4. Paragraph 8.20 discusses the percentage-of-coverage rule.
-

Step 1—Determination of Type A and Type B Programs

8.04 To determine which federal programs are to be audited as major (see step 4), the auditor should first identify federal programs as being either type A or type B as defined in Circular A-133. In general, type A programs are larger federal programs and type B programs are smaller federal programs. The schedule of expenditures of federal awards, prepared by the auditee, provides important program information and assists the auditor with the identification of type A and type B programs. Federal awards expended for purposes of determining type A and type B programs are the amount of cash and noncash awards, after all adjustments are made, in the *final* current-year schedule of expenditures of federal awards, including the notes thereto. An auditor who uses the prior-year schedule or preliminary current-year estimates to plan the audit should recalculate the threshold for type A programs based on the final

amounts to ensure that federal awards are properly classified as type A or B. (For purposes of determining major programs, a cluster of programs should be considered as one program. Chapter 5 of this guide discusses clusters of programs.)

Type A Program Criteria

8.05 The larger federal programs are labeled as type A. Table 8-1 presents the criteria that Circular A-133 establishes for identifying Type A programs.

Table 8-1

Criteria for Identifying Type A Programs

| <i>When Total Federal Awards Expended¹ Are—</i> | <i>A Type A Program Is Any Program With Federal Awards Expended That Exceed the Larger of—</i> |
|-------------------------------------------------------------------------|------------------------------------------------------------------------------------------------|
| More than or equal to \$300,000 and less than or equal to \$100 million | \$300,000 or 3% (0.03) of federal awards expended |
| More than \$100 million and less than or equal to \$10 billion | \$3 million or 0.3% (0.003) of federal awards expended |
| More than \$10 billion | \$30 million or 0.15% (0.0015) of federal awards expended |

¹ Includes both cash and noncash awards.

Type B Program Criteria

8.06 Federal programs that do not meet the type A criteria are considered type B programs.

Effect of Large Loans and Loan Guarantees on Identification of Type A Programs

8.07 Chapter 7 of this guide discusses the various types of noncash awards, including loans and loan guarantees, and when they are recognized as expended and how they are valued for purposes of the Circular A-133 audit. Circular A-133 states that when the auditor applies the dollar criteria shown in table 8-1 to identify type A programs, the inclusion of large loans and loan guarantees should not result in the exclusion of other federal programs as type A programs. (This requirement relates only to loans and loan guarantees and not to any other large noncash awards.) When a federal program providing loans or loan guarantees significantly affects the number or size of type A programs, the auditor should consider the loan or loan guarantee program a type A program and exclude its value in determining other type A programs. The auditor should use professional judgment in determining whether type A programs would be significantly affected in this situation.

8.08 Paragraph 8.09 demonstrates this concept using the example programs in table 8-2 by showing the identification of type A programs as well as the effect of loans and loan guarantees on that identification process.

Table 8-2

**Identification of Type A Programs
and the Effect of Loans and Loan Guarantees**

| <i>Program / Federal Grantor</i> | <i>Federal Awards Expended (\$000)</i> |
|----------------------------------------------------------------------------------------------------------------|----------------------------------------------------|
| Cash program A—U.S. Department of Labor | \$ 1,335 |
| Cash program B—U.S. Department of Health and Human Services | 3,000 |
| Cash program C-1—U.S. Department of Education | 175 |
| Cash program C-2—U.S. Department of Education | 280 |
| Cash program D—U.S. Department of Housing and Urban Development (a pass-through grant from a local government) | <u>310</u> |
| Subtotal—Cash federal awards expended | \$ 5,100 |
| Commodities program E—U.S. Department of Agriculture (a pass-through grant from a state) | <u>2,000</u> |
| Subtotal—Cash and commodities federal awards expended | \$ 7,100 |
| Loan program F—U.S. Department of Housing and Urban Development | 33,500 |
| Loan guarantee program G—U.S. Department of Agriculture | <u>57,000¹</u> |
| Total federal awards expended | <u>\$97,600</u> |

¹ In accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, loans and loan guarantees include new loans made during the year, plus prior-year loans for which the federal government imposes continuing compliance requirements, plus any interest subsidy, cash, or administrative cost allowance received. Chapter 7, "Schedule of Expenditures of Federal Awards," of this guide provides additional information.

8.09 Table 8-2 shows that the auditee has \$97,600,000 in total federal awards expended. Therefore, applying the criteria in table 8-1 indicates that type A programs would be those that expended federal awards equal to or greater than \$2,928,000 (3 percent of \$97,600,000), or programs B, F, and G. However, when large loan and loan guarantee programs F and G are excluded from the base amount of the total federal awards expended in the calculation, the type A programs would be those programs that expended federal awards equal to or greater than \$300,000 (the larger of \$213,000 [3 percent of \$7,100,000] or \$300,000). Therefore, under the second calculation, programs A, B, D, E, F, and G would be type A programs. If the auditor, in his or her professional judgment, concludes that the difference in the number or size of type A programs is significantly affected by the inclusion of the loans and loan guarantees (which in this example would be likely due to the significant increase in type A programs), the auditor would identify programs A, B, D, E, F,

and G as type A programs. The auditor could consider contacting the cognizant or oversight agency for audit if the auditor is unsure about whether to exclude loan or loan guarantees when determining type A programs.

Step 2—Identification of Low-Risk Type A Programs

8.10 After completing step 1, the auditor should perform a risk assessment of each type A program to identify those that are low-risk. Circular A-133 includes certain conditions that, when met, indicate that a type A program may be low-risk.

General Conditions for Low-Risk Type A Programs

8.11 Type A programs generally may be considered low-risk if both of the following conditions are met: (a) the program has been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit) and (b) in the most recent audit period, the program had no audit findings. (Chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide discusses the situations that Circular A-133 requires the auditor to report as audit findings.) It is important for auditors to note that every type A program that was not audited in one of the two prior years should be audited as a major program. If a type A program is new to an entity in the current year (for example, because the entity did not previously participate in the program or because it is a new federal program), it should be audited as a major program in the current year because it was not audited in one of the prior two years. If a program that previously was a type B program is a type A program in the current year (for example, because the funding level increased), and the program was not audited as a major program in one of the two prior years, it should be audited as a major program in the current year. Auditor judgment, as discussed in paragraph 8.12, cannot override the requirement that major programs should include every type A program that (a) was not audited in one of the two prior years or (b) had audit findings other than those indicated in paragraph 8.12.

Auditor Judgment in Determination of Low-Risk Type A Programs

8.12 Circular A-133 permits the auditor to conclude, based on professional judgment, that a type A program is low-risk even though in the prior audit period (a) it may have had known or likely questioned costs greater than \$10,000 for a type of compliance requirement, (b) known fraud has been identified, or (c) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. (The auditor cannot conclude, based on professional judgment, that a type A program is low-risk if there were other types of audit findings, such as significant deficiencies in internal control or material noncompliance.) For example, consider a situation in which the funds expended under a federal program in the prior year totaled \$10 million, there were known questioned costs of \$11,000 that related to one isolated instance, and there were no additional likely questioned costs. In this example, the auditor, based on professional judgment, could decide that the program is low-risk in the current year. In making the final determination of whether a type A program is low-risk, the auditor should also consider the risk criteria in paragraphs 8.26–.36, the results of audit follow-up, and whether any changes in the personnel or systems affecting a type A program have significantly increased its risk. Based

on all of this information, the auditor would apply professional judgment in determining whether a type A program is low-risk.

Type A Program Not Considered Low-Risk at Request of Federal Awarding Agency

8.13 Section 520(c)(2) of Circular A-133 permits a federal awarding agency to request that a type A program for certain recipients not be considered low-risk so that it would be audited as a major program. For example, it may be necessary for a large type A program to be audited as major each year for particular recipients to allow the federal agency to comply with the Government Management Reform Act of 1994. In this instance, Circular A-133 requires the federal awarding agency to obtain approval from the OMB. (OMB has not yet made any such approvals.) Furthermore, the federal awarding agency should notify the recipient and, if known, the auditor at least 180 days before the end of the fiscal year end to be audited. (Paragraph 8.35 discusses the federal agency option to identify federal programs as higher risk in the *OMB Circular A-133 Compliance Supplement* [Compliance Supplement].)

Step 3—Identification of High-Risk Type B Programs

8.14 After completing steps 1–2, the auditor should identify type B programs that are high-risk, using professional judgment and the risk criteria discussed in paragraphs 8.26–.36. Except for known significant deficiencies in internal control or instances of noncompliance, a single risk criterion would, in general, seldom cause a type B program to be considered high-risk.

8.15 Before beginning step 3, this guide recommends the auditor:

- a. Consider whether there are low-risk type A programs. When there are no type A programs identified as low-risk (either because there are no type A programs or because none of the type A programs are low-risk), the auditor is not required to perform step 3. If there are no Type A programs, the auditor would audit as major enough type B programs to meet the percentage-of-coverage rule (see paragraph 8.20). When there are type A programs, but none are low-risk, the auditor would audit as major all type A programs plus any additional type B programs needed to meet the percentage-of-coverage rule. In either case, any programs requested to be audited by a federal agency or pass-through entity should be audited as a major program and would be included in determining whether the percentage-of-coverage rule has been met (see paragraph 8.24).
- b. Consider whether option 1 or option 2 will be used in step 4. (Paragraphs 8.18–.19 describe each option). The auditor's decision of which option to choose will likely be based on audit efficiency and will affect how many type B programs are subject to risk assessment. This guide recommends that the auditor consider the following discussion before deciding whether to use option 1 or option 2.
 - Under option 1, the auditor should perform a risk assessment on all type B programs (excluding small type B programs as discussed in paragraph 8.16). In comparison with option 2, option 1 will likely require the auditor to perform more type B program risk assessments, but may also result in the auditor having to audit fewer major programs. For example, assume

that an auditee has 4 low-risk type A programs and 10 type B programs that exceed the amount specified in table 8-3. Also assume that the auditor chooses option 1. In this scenario, the auditor would be required to perform a risk assessment on all type B programs. If the auditor finds that only four type B programs are high-risk, the auditor would be required to audit only two of the four high-risk type B programs as major (one-half of the number of high-risk type B programs).

- Under option 2, the auditor should identify high-risk type B programs up to the number of low-risk type A programs. In comparison with option 1, option 2 will likely require the auditor to perform fewer type B risk assessments, but may also result in the auditor having to audit more major programs. For example, assume that an auditee has 4 low-risk type A programs and 10 type B programs that exceed the amount specified in table 8-3. Assume also that the first four type B programs subject to risk assessment are determined by the auditor to be high-risk. In this scenario, the auditor may choose option 2, identify the four high-risk type B programs as major, and not perform risk assessments on the remaining six type B programs. Using the same example but assuming that the auditee only has one low-risk type A program (instead of four), the auditor would be required to audit one type B program as major under either option 1 or 2. In this scenario, option 2 would likely be the most efficient choice for the auditor because the auditor would only need to perform type B program risk assessments until one high-risk type B program was identified (under option 1 the auditor would be required to perform a risk assessment on all type B programs).

Criteria for Performing Risk Assessments on Type B Programs

8.16 An auditor is not expected to perform risk assessments on relatively small federal programs. Therefore, Circular A-133 only requires the auditor to perform risk assessments on type B programs that exceed the larger of the criteria shown in table 8-3.

Table 8-3

Criteria for Performing Risk Assessments on Type B Programs

| <i>When Total Federal Awards Expended¹ Are—</i> | <i>Perform Risk Assessment for Type B Programs That Exceed the Larger of—</i> |
|-------------------------------------------------------------------------|-------------------------------------------------------------------------------|
| More than or equal to \$300,000 and less than or equal to \$100 million | \$100,000 or 0.3% (0.003) of federal awards expended |
| More than \$100 million | \$300,000 or 0.03% (0.0003) of federal awards expended |

¹ Includes both cash and noncash awards.

Step 4—Determination of Programs to Be Audited as Major

Criteria for Major Programs

8.17 After completing steps 1–3, the auditor identifies the major programs. At a minimum, Circular A-133 states that the auditor should audit all of the following as major programs:

- All type A programs, except those identified as low-risk under step 2 (see paragraphs 8.10–.13)
- High-risk type B programs as identified under either of the two options described in paragraphs 8.18–.19
- Programs to be audited as major based on a federal agency request (in lieu of the federal agency conducting or arranging for additional audits; paragraph 8.24 provides further information)
- Additional programs, if any, that are necessary to meet the percentage-of-coverage rule described in paragraph 8.20

Two Options Available for Identifying High-Risk Type B Programs

8.18 Section 520(e)(2) of Circular A-133 provides two options for identifying high-risk type B programs:

- *Option 1:* Under option 1, the auditor should perform risk assessments of all type B programs that exceed the amount specified in table 8-3, and to audit at least one-half of the high-risk type B programs as major, unless this number exceeds the number of low-risk type A programs identified in step 2 (that is, the cap). In this case, the auditor would be required to audit as major the same number of high-risk type B programs as the cap. For example, consider an auditee that has 10 low-risk type A programs, and 50 type B programs above the amount specified in table 8-3. Under this option, the auditor would be required to perform risk assessments of the 50 type B programs. Assume that based on that assessment, the auditor determines that there are 25 high-risk type B programs. One-half of the 25 high-risk type B programs is 12.5, which rounds up to 13 programs. Under this option, the auditor would audit 13 of the high-risk type B programs as major; however, since the cap in this example is 10 (that is, the number of low-risk type A programs), the auditor is required to audit only 10 high-risk type B programs as major.
- *Option 2:* Under option 2, the auditor should audit as major only one high-risk type B program for each type A program identified as low-risk in step 2. Under this option the auditor would not be required to perform risk assessments for any type B program when there are no low-risk type A programs (that is, the cap is zero). Continuing with the previous example, under option 2 the auditor would perform risk assessments of type B programs until 10 high-risk programs are identified (that is, 10 is the number of low-risk type A programs). The auditor would then audit as major the 10 type B programs identified as high-risk. Depending on the order in which risk assessments on type B programs are performed, the auditor might only need to perform risk assessments of 10 type B programs determined to be high-risk, or the auditor may need to

perform risk assessments on additional type B programs until 10 high-risk programs are identified.

8.19 The auditor may choose option 1 or option 2. There is no requirement to justify the reasons for selecting either option. The results under options 1 and 2 may vary significantly, depending on the number of low-risk type A programs and high-risk type B programs (see paragraph 8.15). Circular A-133 encourages the auditor to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

Percentage-of-Coverage Rule

8.20 Circular A-133 states that the auditor should audit, as major programs, federal programs with federal awards expended that, in the aggregate, encompass at least 50 percent of the total federal awards expended. However, if the auditee meets the criteria for a low-risk auditee (see paragraph 8.25), the auditor should audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of the total federal awards expended. To comply with this requirement, the auditor should compute the total federal awards expended for the major programs, determined under step 4, as a percentage of the total federal awards expended. If the total does not equal 50 percent (or 25 percent in the case of a low-risk auditee) of the total federal awards expended, the auditor should select additional programs (either type A or type B) to equal 50 percent (or 25 percent in the case of a low-risk auditee) and test them as major programs. The selection of additional programs to meet the percentage-of-coverage is based on the auditor's professional judgment. When selecting additional programs to meet the percentage-of-coverage rule, the auditor may select programs without regard to risk assessment. If loans or loan guarantees are major programs, these programs may be used for purposes of meeting the percentage-of-coverage rule. Furthermore, when a federal agency or pass-through entity requests and pays for a program to be audited as major (see paragraph 8.24), that program may also be used for purposes of meeting the percentage-of-coverage rule.

Documentation of Risk Assessment

8.21 Circular A-133 states that the auditor should document the risk assessment process used in determining major programs. It is therefore necessary for the auditor to develop adequate audit documentation, as required by generally accepted auditing standards (GAAS) and *Government Auditing Standards*, and which includes documentation supporting the determination of major programs. (Chapter 2, "Planning Considerations of *Government Auditing Standards*," and chapter 6, "Planning Considerations of Circular A-133" discuss the audit documentation requirements of GAAS and *Government Auditing Standards*.)

Auditor Judgment in the Risk Assessment Process

8.22 Circular A-133 states that when the determination of major programs is performed and documented by the auditor in accordance with the circular, the auditor's judgment in applying the risk-based approach to determine major programs is presumed correct. Challenges by federal agencies and pass-through entities should be made only for clearly improper use of the guidance in Circular A-133. However, federal agencies and pass-through entities may provide the

auditor with guidance about the risk of a particular federal program, which the auditor should consider when determining major programs.

Other Considerations Regarding the Risk-Based Approach

Deviation From Use of Risk Criteria

8.23 For first-year audits, Circular A-133 section 520(h)(i) allows auditors to deviate from the previously described risk assessment process. A first-year audit is defined as the first year an entity is audited under Circular A-133 or as the first year of a change in auditors. This exception allows the auditor to elect to determine major programs as all type A programs plus any type B programs as are necessary to meet the percentage-of-coverage rule described in paragraph 8.20. Under this option, the auditor is not required to perform steps 2–4 as described in paragraphs 8.10–.19. However, to ensure that a frequent change of auditors would not preclude the audit of high-risk type B programs, this election for first-year audits may not be used more than once every three years. This guide recommends that auditors consider whether this exception is an option during the planning phase of the single audit. (Chapter 6 of this guide discusses other initial-year audit considerations).

Federal Agency and Pass-Through Entity Requests for Additional Major Programs

8.24 Section 215(c) of Circular A-133 permits a federal agency to request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days before the end of the fiscal year to be audited. After consultation with its auditor, the auditee should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if not, the estimated incremental cost. The federal agency should then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based on the federal agency's request, and the federal agency agrees to pay the full incremental costs, then the auditee should have the program audited as a major program. This approach also may be used by pass-through entities for a subrecipient.

Low-Risk Auditee Criteria

8.25 Circular A-133 establishes certain conditions for determining whether an auditee is low risk. An auditee that meets all of the following conditions for each of the preceding two years (or in the case of biennial audits, the preceding two audit periods) qualifies as a low-risk auditee and is eligible for the reduced audit coverage discussed in paragraph 8.20:

- a. Single audits were performed on an annual basis in accordance with Circular A-133. An auditee that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.

- b. The auditor's opinions on the financial statements¹ and the schedule of expenditures of federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of federal awards and may provide a waiver.
- c. There were no deficiencies in internal control over financial reporting that were identified as material weaknesses under the requirements of *Government Auditing Standards*. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of federal awards and may provide a waiver.
- d. None of the federal programs had audit findings from any of the following in either of the preceding two years (or in the case of biennial audits, the preceding two audit periods) in which they were classified as type A programs:
 - Material weaknesses in the internal control over compliance
 - Noncompliance with the provisions of laws, regulations, contracts, or grant agreements that have a material effect on the type A program
 - Known or likely questioned costs that exceed 5 percent of the total federal awards expended for a type A program during the year

Criteria for Federal Program Risk

8.26 Circular A-133 includes certain conditions that, when met, indicate that a type A program may be low-risk (see paragraphs 8.10–.11). As also noted in paragraphs 8.12 and 8.14, in making the final determination of whether a type A program is low-risk or a type B program is high-risk, the auditor should also consider the risk criteria in paragraphs 8.27–.36. The auditor's risk assessment should be based on an overall evaluation of the risk of noncompliance occurring, which could be material to the federal program being evaluated. Circular A-133 indicates that the auditor should use professional judgment and consider certain criteria to identify risk in federal programs. As a part of the risk assessment, the auditor may also wish to discuss a particular federal program with auditee management and with the federal agency or pass-through entity. The rest of this chapter discusses the criteria for federal program risk that are identified in Circular A-133 for the auditor's consideration.

Current and Prior Audit Experience

8.27 The auditor should consider his or her prior experience with the auditee and the results of audits performed in the past. The auditor should consider the following specific factors, as discussed in paragraphs 8.28–.33:

- Weaknesses in the internal control over compliance for federal programs

¹ As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government's basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. For purposes of determining low-risk auditee status for governmental entities, the auditor's opinion on each opinion unit should be unqualified.

- Federal programs administered under multiple internal control structures
- A weak system for monitoring subrecipients when significant parts of federal programs are passed through to subrecipients
- The extent to which computer processing is used
- Prior audit findings
- Federal programs not recently audited as major

Weaknesses in Internal Control Over Federal Programs

8.28 In assessing program risk, the auditor should consider internal control over compliance for federal programs. (See chapter 9, "Consideration of Internal Control Over Compliance for Major Programs," of this guide.) Weak internal control over compliance for federal programs is an indication of higher risk. Consideration also should be given to the control environment over federal programs and to such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements. The auditor may also consider the competence and experience of the personnel who administer federal programs. An indication of higher risk would exist in instances in which the staff are new or do not have experience with a program.

Federal Programs Administered Under Multiple Internal Control Structures

8.29 Federal programs administered by multiple internal control structures may have a higher risk. This often occurs when multiple organizational units (for example, locations or branches) are involved in the administration of federal programs. An example of this would be a university that has several campuses administering a federal program. When assessing risk, the auditor should consider whether any internal control weaknesses are isolated in a single operating unit (that is, one college campus) or are pervasive throughout the entity. If the identified weaknesses are isolated, and absent other weaknesses, the auditor could still potentially reach the conclusion that the program is low-risk. The final determination would be based on the auditor's judgment.

Weak System for Monitoring Subrecipients

8.30 Consideration should be given to the extent that federal programs are passed through to subrecipients. Circular A-133 states that when significant parts of a federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk. Alternatively, if the auditee passes a significant portion of programs to subrecipients and the auditee has an effective system in place to monitor the subrecipients, this might be indicative of a lower level of risk to the program.

Extent to Which Computer Processing Is Used

8.31 When assessing risk, Circular A-133 states that the auditor should consider the extent to which computer processing is used to administer federal programs, as well as the complexity of that processing. A complex system does not always indicate higher risk. On the other hand, a newly installed system that has not been tested in the past, or a recently modified system, may indicate higher risk. AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), and AU section 314, *Understanding the Entity and its Environment and*

Assessing the Risks of Material Misstatement (AICPA, *Professional Standards*, vol. 1), contain requirements and guidance when significant auditee information is transmitted, processed, maintained, or accessed electronically.

Prior Audit Findings

8.32 As a part of the risk assessment, Circular A-133 states that the auditor should consider prior audit findings. In addition, as discussed in chapter 2 of this guide, paragraph 4.09 of *Government Auditing Standards* establishes an additional fieldwork standard that states the auditor should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements. This information should be used in assessing risk and determining the nature, timing, and extent of current audit work. An indication of higher risk would exist for prior audit findings that could have a significant impact on a federal program or for which no corrective action has been implemented since the findings were identified. These findings may be the result, for example, of previous single audits by independent auditors or of compliance or financial audits performed by internal auditors or government auditors in conjunction with the federal awarding agency's monitoring activities.

Federal Programs Not Recently Audited as Major

8.33 Federal programs that have not recently been audited as major programs may be of higher risk than federal programs recently audited as major. For example, many type B programs may never have been audited as major programs in the past. A higher level of risk would likely be assessed on such programs than on those programs that have been consistently audited as major programs without audit findings.

Oversight Exercised by Federal Agencies and Pass-Through Entities

8.34 The oversight exercised by federal agencies or pass-through entities could indicate risk. An important factor in assessing risk is the results of recent audits performed by federal agencies or pass-through entities. For example, recent monitoring or other reviews that were performed by an oversight entity and that disclosed no audit findings may indicate lower risk, whereas monitoring that disclosed significant findings could indicate higher risk. However, reviews performed by federal agencies or pass-through entities vary widely as to coverage and intensity. Therefore, consideration of the scope of reviews performed may assist the auditor in evaluating whether the reviews increase, decrease, or have no impact on risk.

8.35 Section 525(c)(2) of Circular A-133 states that federal agencies, with the concurrence of the OMB, may identify federal programs that are higher-risk. That identification is provided by the OMB in the *Compliance Supplement*. For example, the U.S. Department of Health and Human Services has identified the Medicaid Assistance Program as a program of higher risk in the *Compliance Supplement*. Although such an identification by a federal agency does not preclude an auditor from determining that a program is low-risk (for example, because prior audits have shown strong internal control and compliance), the auditor should consider it as part of the risk assessment process.

Inherent Risk of the Federal Programs

8.36 As part of the risk assessment, the auditor should consider the inherent risk of federal programs. The nature of some programs may indicate higher inherent risk. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides the following examples of program characteristics with potentially higher inherent risks:

- Complex programs and the extent to which a program contracts for goods and services have the potential for higher risk. For example, federal programs that disburse funds through third-party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high risk for time-and-effort reporting but may otherwise be at low risk.
- The phase of a federal program's life cycle at the federal agency may indicate risk. For example, a new program with new or interim regulations may have a higher risk than an established program with time-tested regulations. In addition, significant changes in federal programs, laws, or regulations or in the provisions of contracts or grant agreements may increase risk.
- The phase of a program's life cycle at the auditee may indicate risk. For example, during the first and last years in which an auditee participates in a program, the risk may be higher because of the start-up or closeout of the program's activities and staff.
- Type B programs with larger federal awards expended would be of higher risk than would programs with substantially smaller federal awards expended.

Chapter 9

Consideration of Internal Control Over Compliance for Major Programs

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133), is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (Chapters 2–4 of this guide), discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in Part I of this guide in addition to the guidance in Part II, "Circular A-133 Audits" (Chapters 5–13 of this guide).

9.01 Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133), establishes requirements for additional audit procedures and reporting relative to the auditor's consideration of internal control over compliance for major programs. Those requirements are beyond those of a financial statement audit conducted in accordance with GAAS and *Government Auditing Standards*. Chapter 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide discusses the auditor's consideration of internal control over financial reporting in a financial statement audit, including a Circular A-133 audit. (As discussed in Chapter 6, "Planning Considerations of Circular A-133," of this guide, Circular A-133 does not impose on the financial statement audit any additional audit requirements beyond *Government Auditing Standards*.) This chapter discusses the additional considerations of internal control over compliance for major programs. Paragraph 9.03 and chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide discuss the reporting on internal control over compliance for major programs.

Summary of Circular A-133 Requirements Related to Internal Control Over Compliance for Federal Programs

Auditee Responsibilities

9.02 Circular A-133 states that the auditee should maintain internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and provisions of contracts or grant agreements that could have a material effect on each of its federal programs (hereinafter referred to as *compliance requirements*).

Auditor Responsibilities

9.03 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133, as amended in a *Federal Register* Notice on June 26, 2007,^{*} states that the auditor should

- perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs.
- plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.¹
- perform testing of internal control over compliance as planned.
- report on internal control over compliance describing the scope of the testing of internal control and the results of the tests and, where applicable, referring to the separate schedule of findings and questioned costs. This schedule includes, where applicable, a statement that significant deficiencies in internal control over compliance for major programs were identified in the audit and whether any such deficiencies were material weaknesses.

Auditor Responsibility for Internal Control Over Compliance for Programs That Are Not Major

9.04 The auditor has no responsibility under Circular A-133 to obtain an understanding of internal control over compliance for programs that are not considered major, or to plan or perform any related testing of internal control over compliance for those programs except for any procedures the auditor may choose to perform as part of the risk assessment process in determining major programs. (Chapter 8, "Determination of Major Programs," of this guide discusses the risk assessment process.) However, a program that is not considered major could still be material to the financial statements.² In that situation, in conjunction with the financial statement audit, the auditor may need to obtain an understanding of that program's internal control over financial reporting.

Circular A-133 Definition of Internal Control Over Federal Programs

9.05 Circular A-133 defines internal control over federal programs as follows:

^{*} The *Federal Register* Notice can be found on the Office of Management and Budget (OMB) Web site at www.whitehouse.gov/omb/fedreg/2007/062607_audits.pdf.

¹ See paragraphs 9.22–.25 for a discussion of planning the testing of internal control over compliance to support a low assessed level of control risk. See paragraphs 9.26–.28 for situations where the internal control over some or all of the compliance requirements for a major program is likely to be ineffective.

² As discussed in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor's consideration of materiality for purposes of planning, performing, evaluating the results of, and reporting on the audit of the financial statements of a state or local government is based on opinion units. See that guide for further guidance.

Internal control pertaining to the compliance requirements for federal programs (*internal control over federal programs*) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for federal programs:

1. Transactions are properly recorded and accounted for to:
 - a. Permit the preparation of reliable financial statements and federal reports;
 - b. Maintain accountability over assets; and
 - c. Demonstrate compliance with laws, regulations, and other compliance requirements;
2. Transactions are executed in compliance with:
 - a. Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program; and
 - b. Any other laws and regulations that are identified in the compliance supplement; and
3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Control Objectives and the Elements of Internal Control

9.06 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), states that there are three objectives of internal control: reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. There is a direct relationship between an entity's objectives and the internal control components it implements to provide reasonable assurance about their achievement. For purposes of this guide, controls relevant to the audit of the financial statements are referred to as "internal control over financial reporting" and are encompassed in the report on internal control over financial reporting that is required by *Government Auditing Standards*. (See chapters 3 and 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide.) Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this guide as "internal control over compliance" and are encompassed in the report on internal control over compliance required by Circular A-133. In a particular single audit engagement, some controls may be relevant to both the audit of the financial statements and the audit of compliance. When this occurs, those controls would be encompassed in both internal control reports. Chapter 12 of this guide provides guidance on reporting findings involving significant deficiencies in internal control in such a circumstance.

9.07 AU section 314 states that internal control consists of five interrelated components

- *Control environment* sets the tone of the organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

- *Risk assessment* is the entity's identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed.
- *Information and communication systems* support the identification, capture, and exchange of information in a form and time-frame that enable people to carry out their responsibilities.
- *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- *Monitoring* is a process that assesses the quality of internal control performance over time.

These components assist the auditor in considering how the different aspects of an entity's internal control may affect the audit. When considering internal control over compliance for major programs the auditor's focus is on the internal control objective related to compliance with laws, regulations, and the provisions of contracts or grant agreements.

Auditor's Consideration of Internal Control Over Compliance for Each Major Program

9.08 The auditor's consideration of internal control over compliance for each major program is similar to the consideration of internal control over financial reporting in a financial statement audit as described in AU section 314. The same concepts apply regarding assessing risk, understanding internal control over compliance, and the testing of controls. However, instead of the objective being reliability of financial reporting, it is compliance with laws, regulations, and the provisions of contracts or grant agreements.

9.09 When considering internal control over compliance, the auditor should obtain an understanding of the five elements of internal control sufficient to assess the risks of material noncompliance with each direct and material compliance requirement for each major program. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to the compliance audit and to determine whether they have been implemented. The auditor should use the information gathered by performing the risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The risk assessment should be used to determine the nature, timing and extent of further audit procedures to be performed. When the risk assessment is based on an expectation that controls are operating effectively, the auditor should perform tests of controls to support a low assessed level of control risk.

9.10 Procedures for gaining an understanding of internal control over compliance and an assessment of the risks of noncompliance may be performed concurrently in an audit. Similarly, based on the assessed level of control risk that the auditor expects to support and on audit efficiency considerations, the auditor may perform some tests of controls concurrently with obtaining an understanding of controls. See also paragraph 9.29 for information on the testing of controls.

Obtaining an Understanding of Internal Control Over Direct and Material Compliance Requirements for Major Programs

Understanding Direct and Material Compliance Requirements and Identifying Relevant Controls

9.11 As noted in paragraph 9.03, the auditor should perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs. (Chapter 8 of this guide discusses the determination of major programs.) In order to do this, an understanding is needed of which of the 14 types of compliance requirements identified in the OMB Circular A-133 Compliance Supplement (Compliance Supplement) have a direct and material effect on each major program. (See also chapter 10, "Compliance Auditing Applicable to Major Programs" for a discussion of identifying applicable, direct and material compliance requirements.) Once the auditor has identified those compliance requirements that have a direct and material effect on each major program, the understanding of the direct and material compliance requirements will determine the types of controls the auditor needs to consider in a single audit.

9.12 In order to identify the controls relevant to the direct and material compliance requirements, the auditor should obtain an understanding of the five components of internal control in relation to the direct and material compliance requirements for each major program. In obtaining an understanding of internal control, paragraphs .54–.56 of AU section 314 provide requirements and guidance. Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves consideration of whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting instances of noncompliance. Implementation of a control means that the control exists and that the entity is using it. The auditor should consider the design of the control in determining whether to consider its implementation. (See paragraph 9.26 for a discussion of ineffective internal control.)

9.13 The auditor should perform risk assessment procedures as found in paragraph .06 of AU section 314. The objective of these procedures is to obtain audit evidence about the design and implementation of relevant controls and may include inquiry of entity personnel, observing the application of a specific control, and inspecting documents and reports. Paragraph .55 of AU section 314 states that inquiry alone is not sufficient to evaluate the design of a control and to determine whether it has been implemented. (See chapter 6 for a discussion of risk assessment.)

9.14 The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. The use of IT affects the fundamental manner in which transactions are initiated, authorized, recorded, processed, and reported. When IT is used for these purposes, the systems and programs may include controls related to direct and material compliance requirements or may be critical to the effective functioning of manual controls that depend on IT. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT. (See

paragraphs .57–.63 of AU section 314 for more guidance on the effect IT has on the auditor's risk assessment process.)

9.15 Obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls, unless there is some automation that provides for the consistent application of the operation of the control. Further, simply testing compliance in accordance with Circular A-133 does not provide evidence that controls are operating effectively. Testing compliance gives indirect evidence on the effectiveness of controls, but cannot serve as the basis for assessing controls as operating effectively. Generally, testing controls assists the auditor in determining the nature, timing, and extent of substantive audit procedures to perform in order to gather evidence related to the opinion on compliance.

9.16 Entities may use the same controls for more than one federal program and for similar transactions (for example, cash disbursements). Accordingly, those controls will often provide assurance regarding the achievement of the compliance objectives related to some or all federal program transactions and assets. However, the use of the same controls does not negate the need to gain an understanding for each major program.

Compliance Supplement Internal Control Guidance

9.17 Part 6 of the *Compliance Supplement* provides the auditor with guidance and a general discussion of the control objectives, components, and activities that are likely to apply to the 14 types of compliance requirements. (Chapter 10 of this guide discusses the *Compliance Supplement* and the types of compliance requirements.) In addition, for 13 of the 14 types of compliance requirements, objectives of internal control and examples of characteristics specific to the compliance requirements follow the general information. (The compliance requirement—"Special Tests and Provisions" is excluded because that requirement is unique to each program). The guidance in the *Compliance Supplement* is not a checklist of required internal control characteristics; it is intended, instead, to assist the auditor in planning and performing the single audit. However, the auditee is responsible for designing and implementing internal control that is sufficient to provide reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and provisions of contracts or grant agreements that could have a material effect on each of its federal programs. The auditee may need to design and implement control activities beyond those discussed in the *Compliance Supplement* to meet that responsibility. Similarly, the auditor is responsible for evaluating internal control over compliance and for planning the audit to support a low assessed level of control risk for each major program. The auditor may need to perform tests of internal control over compliance that are related to control objectives and activities in addition to those discussed in the *Compliance Supplement*.

Multiple-Component Considerations

9.18 Federal programs often are administered by multiple organizational units (for example, locations or branches) within an auditee. Each component may maintain separate internal control over compliance that is relevant to the programs, or parts of the programs, that the component administers. In these situations, the auditor should perform procedures to obtain an understanding of internal control over compliance that is separately maintained by

organizational units and that is relevant to each material part of a major program, and should plan and perform testing of those controls as discussed in this chapter. (Chapters 8 and 10 of this guide discuss other multiple-component considerations.)

Subrecipient Considerations

9.19 Many entities that are pass-through entities for federal awards make subcontract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients. The auditor of the pass-through entity has certain responsibilities related to the entity's internal control over the monitoring of subrecipients. If significant pass-through funds are awarded, subrecipient considerations could have a major impact on the risk assessment and internal control procedures performed. Chapter 11, "Audit Considerations of Federal Pass-Through Awards," discusses the audit considerations of federal pass-through awards.

Planning and Performing the Test of Operating Effectiveness of Internal Control Over Direct and Material Compliance Requirements for Each Major Program

Assessing Control Risk

9.20 Control risk is the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the auditee's internal control. After obtaining an understanding of internal control over compliance for major programs, the auditor makes a preliminary assessment of control risk related to the direct and material compliance requirements for major programs. This information is used to determine whether the auditor can support a low assessed level of control risk. When the auditor believes, based on the understanding of internal control, that controls are capable of effectively preventing or detecting and correcting material noncompliance, the auditor may initially assess control risk at less than the maximum during the risk assessment phase of the audit. (See also chapter 6 of this guide, which discusses audit risk considerations in a compliance audit, including control risk.)

9.21 The assessment of control risk is the process of evaluating preliminarily the effectiveness of an entity's internal control over compliance in preventing or detecting material noncompliance with the compliance requirements for each major program. Paragraphs 9.22–.25 discuss the Circular A-133 requirement to plan the testing of internal control over compliance to support a low assessed level of control risk. Paragraphs 9.26–.28 discuss the auditor's responsibilities when internal control over compliance is ineffective in preventing or detecting noncompliance. The auditor's basis for judgment of the assessed level of control risk should be documented to support the decisions made. See paragraph 9.49 for a further discussion of audit documentation as it relates to internal control over compliance. The auditor should consider the results of his or her assessment of control risk, and any additional controls or tests of operating effectiveness in designing the nature, extent, and timing of substantive tests of compliance.

Planning the Test of Operating Effectiveness of Internal Control Over Compliance for Each Major Program to Support a Low Assessed Level of Control Risk

9.22 Circular A-133 states that the auditor should plan the test of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. Professional standards do not define or quantify a low assessed level of control risk. Therefore, the auditor should exercise professional judgment to determine the extent of control testing necessary to obtain a low level of control risk. In exercising professional judgement, the auditor should consider the purpose of the requirement to plan the tests of controls to achieve a low assessed level of control risk (that is, federal agencies want to know if conditions indicate that auditees have not implemented adequate internal control over compliance for federal programs to ensure compliance with applicable laws and regulations).

9.23 The auditor should obtain sufficient appropriate audit evidence to support that assessed level of control risk. The type of audit evidence, its source, its timeliness, and the existence of other audit evidence related to the conclusions to which it leads all bear on the degree of assurance the audit evidence provides.

9.24 The guidance in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance regarding the testing of internal control. Although this AU section is written from the perspective of a financial statement audit, it does provide general guidance regarding internal control testing that is applicable when testing internal control over compliance. Paragraph .36 of AU section 318 states that the auditor should test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls. If the auditor needs audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient, and the auditor should supplement those tests with other tests of controls that are capable of providing audit evidence that the control operated effectively at relevant times during the period under audit. This guidance, along with the Circular A-133 requirement to perform the testing of internal control to support a low assessed level of control risk, supports the testing of internal control over compliance every year.

9.25 Paragraphs .46–.49 of AU section 318 also contain guidance related to the extent of tests of controls. The auditor should design sufficient tests of controls to obtain sufficient appropriate audit evidence that the controls are operating effectively throughout the period of reliance. Several factors are listed that auditors may consider in determining the extent of the tests of controls:

- The frequency of the performance of the control by the entity during the period
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control
- The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the relevant assertion level

- The extent to which audit evidence is obtained from tests of other controls related to the relevant assertion
- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control)
- The expected deviation from the control

Paragraph .48 of AU section 318 states that the auditor should increase the extent of tests of controls the more the auditor relies on the operating effectiveness of controls in the assessment of risk. In addition, as the rate of expected deviation from a control increases, the auditor should increase the extent of testing of the control. However, the auditor should consider whether the rate of expected deviation indicates that obtaining audit evidence from the performance of tests of controls will not be sufficient to reduce control risk at the relevant assertion level. If the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may be inappropriate.

Existence of Ineffective Internal Control in Preventing or Detecting Noncompliance

9.26 While gaining an understanding of internal control over compliance, if the auditor determines that internal controls over compliance for some or all of the compliance requirements for a major program have not been implemented or are likely to be ineffective in preventing or detecting noncompliance, the auditor is not required to plan and perform tests of internal control over compliance as described in paragraphs 9.03, 9.22, and 9.29. If internal control over compliance is deemed likely to be ineffective, Circular A-133 states that the auditor should assess control risk at the maximum and consider whether any additional compliance tests are required because of ineffective internal control. The auditor also should report a significant deficiency or a material weakness as part of the audit findings. (Chapter 12 discusses the reporting of significant deficiencies and material weaknesses.)

9.27 The assessment of the effectiveness of internal control over compliance in preventing, detecting, and correcting noncompliance is determined in relation to each individual type of compliance requirement or to an audit objective identified in the *Compliance Supplement* for each major program. For example, controls over requirements for eligibility may be ineffective because of a lack of segregation of duties. In this case, the auditor should

- Report the lack of segregation of incompatible duties as it relates to eligibility as a significant deficiency or a material weakness
- Assess the control risk related to requirements for eligibility at the maximum.
- Consider the lack of effective control when designing the nature, timing, and extent of procedures designed to test compliance with requirements for eligibility of the major program. In most cases, the extent of testing would need to be expanded.

9.28 In planning the tests of controls, consideration of the results of tests performed in prior years provides the auditor with important information. If the results of the prior year tests of controls prevented the auditor from assessing

a low level of control risk, the auditor may consider expanded testing in the current audit period. Testing of any changes in internal control over compliance that were intended to eliminate deficiencies noted in the previous year also may provide relevant information. If, however, the auditee has made no changes to its internal control over compliance, the auditor may determine that controls are not likely to be effective and may choose not to plan and perform tests of controls. In this situation, the auditor should report a significant deficiency or a material weakness as discussed in paragraph 9.26.

Performing Tests to Evaluate the Effectiveness of Controls

9.29 As discussed in paragraph .26 of AU section 318, testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied.

9.30 As noted in paragraph 9.03, Circular A-133 states that the auditors should perform tests of internal controls over compliance as planned. (Paragraphs 9.26–.28 discuss an exception related to ineffective internal control over compliance. In addition, paragraph .24 of AU section 318 states that the auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of control. Testing of the operating effectiveness of controls ordinarily includes procedures such as (a) inquiries of appropriate entity personnel, including grant and contract managers; (b) the inspection of documents, reports, or electronic files indicating performance of the control; (c) the observation of the application of the specific controls; and (d) reperformance of the application of the control by the auditor. The auditor should perform such procedures regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level.

9.31 Paragraph .33 of AU section 318 provides guidance related to the testing of controls. When responding to the risk assessment, the auditor may design a test of controls to be performed concurrently with a test of details on the same transactions. Although the objectives of the tests are different, both may be accomplished concurrently through performance of a test of controls and a test of details on the same transaction (a dual-purpose test). For example, the auditor may examine an invoice to determine whether it has been approved and to provide substantive evidence of a transaction. The auditor should carefully consider the design and evaluation of such tests in order to accomplish both objectives. Also, when performing the tests, the auditor should consider how the outcome of the test of controls may affect the auditor's determination about the extent of substantive procedures to be performed.

Evaluating the Results of Tests of Controls

9.32 Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessment of the risk of material noncompliance of the relevant compliance requirements remain appropriate. An audit is a cumulative and iterative process. As the auditor performs

planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessments were based. The auditor should determine whether the tests of controls performed provide an appropriate basis for reliance on the controls, whether additional tests of controls are necessary or whether the potential risks of noncompliance need to be addressed using substantive procedures. Furthermore, the auditor should not assume that an instance of fraud or error is an isolated occurrence, and therefore should consider how the detection of such noncompliance affects the assessed risk of material noncompliance. Before the conclusion of the audit, the auditor should evaluate whether audit risk has been reduced to an appropriately low level and whether the nature, timing and extent of the audit procedures need to be reconsidered. The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an appropriately low level the risks of material noncompliance with compliance requirements. In developing an opinion on compliance, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the relevant assertions.

9.33 If, when evaluating the results of tests of controls, the auditor is not able to support a low assessed level of control risk for major programs, the auditor is not required to expand his or her testing of internal control over compliance. The auditor may choose not to perform further tests. In that situation, the auditor would assess control risk at other than low, design tests of compliance accordingly, and consider the need to report an audit finding. (Chapter 12 of this guide discusses the situations that Circular A-133 requires the auditor to report as audit findings.) In general, a significant deficiency or a material weakness will need to be reported.

9.34 The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. When such deviations are detected during the performance of tests of controls, the auditor should make specific inquiries to understand these matters and their potential consequences. In addition, the auditor should consider whether any noncompliance detected from the performance of substantive procedures alter the auditor's judgment as to the effectiveness of the related controls. The auditor should determine whether the tests of controls performed provide an appropriate basis for reliance on the controls, whether additional tests of controls are necessary, or whether the potential risks of noncompliance need to be addressed using substantive procedures.

9.35 On the other hand, the auditor may decide to expand the testing of internal control over compliance, but that decision would be based on whether the auditor considered expanded internal control testing to be more efficient than additional tests of compliance. Based on the testing performed, control risk might be assessed below the maximum and therefore reduce substantive tests of compliance. If it cannot be assessed below the maximum, it might be more appropriate to assess control risk at the maximum level.

9.36 Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to the compliance requirements for major programs. Because effective controls generally reduce, but do not eliminate, risks of material noncompliance, tests of controls reduce, but do not eliminate the need for substantive procedures.

Significant Deficiencies and Material Weaknesses Related to Federal Programs

9.37 For purposes of reporting on internal control over compliance for federal programs, the definitions of a significant deficiency and a material weakness, as found in paragraphs .01–.04 of Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit," of AU section 325A (AICPA, *Professional Standards*, vol. 1, AU sec. 9325A par. .01–.04), are as follows:

- A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood³ that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential⁴ will not be prevented or detected.
- A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected.

9.38 In performing a single audit, significant deficiencies and material weaknesses related to internal control over compliance and material noncompliance with provisions of laws, regulations, contract or grant agreements are to be considered as they relate to a type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. Further, certain conditions may be significant deficiencies for a major program and not be considered significant deficiencies as they relate to the assertions of management in the financial statements.

9.39 In a single audit, the significance of a control deficiency depends on the potential for noncompliance, not on whether noncompliance actually has occurred. Accordingly, the absence of identified noncompliance does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses. When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of actual or potential noncompliance.

9.40 The following are examples of factors that may affect the likelihood that a control, or combination of controls, could fail to prevent or detect noncompliance:

- The nature of the type of compliance requirement involved. For example, a specific special test or provision may involve greater

³ Per paragraph .03 of Interpretation No. 1 of AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), the term *remote likelihood* as used in the definitions of the terms *significant deficiency* and *material weakness* has the same meaning as the term *remote* as used in Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*. Therefore, the likelihood of an event is "more than remote" when it is at least reasonably possible.

⁴ Per paragraph .03 of Interpretation No. 1 of AU section 325A, "Noncompliance with a type of compliance requirement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected noncompliance, that the noncompliance, either individually or when aggregated with other noncompliance related to the same type of compliance requirement, would clearly be immaterial to a federal program."

risk because it is unique to the program and may require unique controls.

- Susceptibility of the program and related types of compliance requirements to fraud;
- Subjectivity and complexity involved in meeting the compliance requirement, and the extent of judgment allowed;
- Cause and frequency of any known or detected exceptions related to the operating effectiveness of a control;
- Interaction or relationship of the control with other controls;
- Interaction of the control deficiency with other control deficiencies; or
- Possible future consequences of the deficiency.

9.41 The evaluation of control deficiencies includes the magnitude of potential noncompliance. Several factors affect the magnitude of potential noncompliance that could result from a deficiency or deficiencies in controls. The factors may include, but are not limited to, the following:

- Program amounts or total of transactions exposed to the deficiency, in relation to the type of compliance requirement;
- Volume of activity related to the compliance requirement exposed to the deficiency in the current period or expected in future periods; or
- Adverse publicity or other qualitative factors.

9.42 Multiple control deficiencies that affect the same type of compliance requirement increase the likelihood of noncompliance and may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Therefore, the auditor should evaluate individual control deficiencies that affect the type of compliance requirement, or component of internal control, to determine whether they collectively result in a significant deficiency or material weakness.

9.43 In determining whether a control deficiency or combination of control deficiencies is a significant deficiency or material weakness, the auditor also should evaluate the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the audit of a major program. A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected noncompliance, which would result in the prevention or detection of noncompliance that is more than inconsequential or material to the type of compliance requirement. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency. The auditor could evaluate and test the effectiveness of a compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the control deficiency in the type of compliance requirement.

9.44 The auditor may encounter deviations in the operating effectiveness of controls. A control that has an observed nonnegligible deviation rate is at least a control deficiency regardless of the reason for the deviation, and could be, based upon further evaluation, a significant deficiency or material weakness.

For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

9.45 The auditor should conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency. Although the term prudent official is not defined in the standard, the concept is that an auditor should "stand back" and take another objective look at the severity of the deficiency much as would a regulator or someone from an oversight agency.

9.46 For purposes of a single audit, deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Policies and procedures that are incomplete, inadequate, or outdated for the activities subject to a type of compliance requirement
- Inadequate segregation of duties over a type of compliance requirement
- Inadequate controls over complex types of compliance requirements
- Inadequate IT controls relating to the activity subject to the type of compliance requirement

9.47 Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Lack of operating policies and procedures for the activities subject to a type of compliance requirement.
- Ineffective oversight of a major federal program by those charged with governance over compliance with those program requirements where the activity is subject to the type of compliance requirement, for example, lack of adequate review of federal financial reports prior to submission to the grantor.
- Identification by the auditor of material noncompliance for the period under audit that was not initially identified by the entity's internal control. (This is a strong indicator of a material weakness even if management subsequently corrects the noncompliance.)
- An ineffective internal audit function or risk assessment function for a major program for which such functions are important to the monitoring or risk assessment component of internal control for a type of compliance requirement.
- Identification of fraud in the major program of any magnitude on the part of senior program management. For the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude—including fraud resulting in immaterial noncompliance—on the part of senior program management, of which he or she is aware.
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected.
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude

that a significant deficiency or material weakness exists in the control environment over compliance with major program requirements.

Program Cluster Considerations

9.48 An entity may have separate controls related to individual federal programs that are treated as one program "cluster" under a Circular A-133 audit, such as student financial aid (SFA) and research and development (R&D). (Chapter 5, "Overview of the Single Audit Act, Circular A-133, and the *Compliance Supplement*," of this guide discusses clusters of programs.) In this case, when evaluating whether an identified deficiency is a significant deficiency, the auditor should consider the significance of the deficiency in relation to the type of compliance requirement for the overall major program (program cluster). Following are some examples:

- Deficiencies in specific controls over the time cards of college work-study students would likely be considered significant deficiencies when college work-study program expenditures are significant in relation to SFA programs.
- Deficiencies in controls over a single campus or department of a university where a significant amount of research was administered would likely be significant deficiencies when considered in relation to the total expenditures of R&D programs.
- A deficiency in an SFA or R&D program that was clearly insignificant to the SFA or R&D program, respectively, as a whole would not necessarily be considered a significant deficiency.

Documentation Requirements

9.49 As discussed in paragraph .122 of AU section 314, the auditor should document the following related to his or her understanding of internal control related to compliance requirements:

- The discussion among the audit team regarding the susceptibility of the entity's major programs to direct and material noncompliance with compliance requirements, including how and when the discussion occurred, the subject matter discussed, the audit team members who participated, and significant decisions reached concerning planned responses to compliance requirements
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment, in this case as it relates to internal control over compliance, to assess the risks of material noncompliance, the sources of information from which the understanding was obtained; and the risk assessment procedures performed
- The assessment of risks of material noncompliance and the basis for the assessment
- The risks identified and related controls evaluated as a result of the requirements in paragraphs .110 and .117 of AU section 314

9.50 Paragraph .77 of AU section 318 contains requirements regarding documentation of the testing of controls. Among the matters discussed in that guidance that is of particular relevance to a single audit is that the auditor should document the following:

- The overall responses to address the assessed risks of noncompliance as it relates to compliance requirements of major programs
- The nature, timing, and extent of further audit procedures
- The linkage of those procedures with the assessed risks at the relevant assertion level
- The results of the audit procedures

9.51 As noted in chapter 2, "Planning Considerations of *Government Auditing Standards*," of this guide, AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1) provides guidance on the form, content, extent, retention, and confidentiality of audit documentation as required by GAAS. Among other things, AU section 339 requires audit documentation to be sufficient to enable an experienced auditor, having no previous connection to the audit, to understand

- the nature, timing, extent, of auditing procedures performed to comply with Government Auditing Standards and other applicable standards and requirements, such as single audit requirements
- the results of the audit procedures performed and the audit evidence obtained
- the conclusions reached on significant matters and
- that the accounting records agree or reconcile with the audited financial statements or other audited financial information.

AU section 339 contains guidance on documenting significant findings or issues; identifying the preparer and reviewer of audit documentation; documenting specific items tested; documenting departures from relevant SASs; revising audit documentation after the date of the auditor's report; and ownership and confidentiality of audit documentation. Paragraph 4.20 of *Government Auditing Standards* includes an additional standard that states that auditors should document, before the report is issued, evidence of supervisory review of the work performed that supports findings, conclusions, and recommendations contained in the audit report.

9.52 The form and extent of this documentation are influenced by the size and complexity of the auditee, as well as the nature of the auditee's internal control over compliance. For example, the documentation of the understanding of internal control over compliance of a large, complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, the documentation may be less extensive. In general, the more complex internal control over compliance and the more extensive the procedures performed, the more extensive the auditor's documentation.

Consideration of Abuse

9.53 As discussed in chapter 3 of this guide, paragraphs 4.10–.13 of *Government Auditing Standards* discuss its additional fieldwork standard that requires auditors to be alert to situations or transactions that could be indicative

of abuse.⁵ Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse. However, if auditors become aware of indications of abuse that could be quantitatively or qualitatively material to the financial statement amounts, they should apply audit procedures specifically directed to ascertain whether abuse has occurred and the potential effect on the financial statement amounts or other financial data significant to the audit objectives. That standard, like all of the general, fieldwork, and reporting standards in *Government Auditing Standards*, applies to the entirety of the A-133 audit, including the compliance audit. Therefore, if in performing procedures on major programs, the auditor becomes aware of a situation or transaction that might constitute abuse, the auditor should extend procedures to determine whether it is indicative of abuse and potentially material to the financial statement amounts⁶ or to the major program. Chapter 3 of this guide further discusses procedures relating to and the evaluation of indications of abuse and chapter 8 of this guide discusses the nature of abuse as it relates to federal awards. Chapter 12 of this guide discusses the reporting of abuse involving federal awards.

⁵ Paragraph 4.19 of *Government Auditing Standards* describes "abuse" by stating that it is distinct from fraud, illegal acts, and violations of provisions of contracts or grant agreements. Abuse, it states, "involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances."

⁶ See footnote 2 in paragraph 9.04.

Chapter 10

Compliance Auditing Applicable to Major Programs

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (Chapters 2–4 of this guide), discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in part I of this guide in addition to the guidance in part II, "Circular A-133 Audits" (Chapters 5–13 of this guide).

10.01 This chapter discusses the auditor's consideration of compliance requirements applicable to major programs in a single audit under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). (As discussed in chapter 13, "Program-Specific Audits," of this guide, much of the guidance in this chapter also would be applicable to a program-specific audit when a program-specific audit guide is not available). Chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide discusses the related reporting requirements. Chapters 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," and 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide discuss the auditor's consideration of and reporting on the auditee's compliance with laws, regulations, and provisions of contracts or grant agreements in a financial statement audit.

Single Audit Compliance Objectives

10.02 In addition to a financial statement audit in accordance with GAAS and *Government Auditing Standards*, Circular A-133 states that the auditor should determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs (hereinafter referred to as *compliance requirements*). A single audit results in the auditor expressing an opinion on the auditee's compliance with those compliance requirements for each of its major programs. To express such an opinion, the auditor accumulates sufficient appropriate audit evidence by planning, performing risk assessment procedures, and performing tests of transactions and such other auditing procedures as are necessary in support of the entity's compliance with direct and material compliance requirements, thereby limiting audit risk to an appropriately low level.

Responsibilities of Auditee

10.03 The auditee is responsible (a) for complying with the compliance requirements related to each of its federal programs and (b) for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. Paragraphs 10.66–.68 discuss how the auditor has a responsibility to obtain management's written representations regarding its compliance and internal control responsibilities.

10.04 The form and extent of the documentation of management's compliance will vary depending on the nature of the compliance requirements and the size and complexity of the entity. The auditee may have documentation in the form of accounting or statistical data, case files, entity policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports.

Use of Professional Judgment

10.05 The planning, conduct, and evaluation of the results of compliance testing in a single audit require the auditor to exercise professional judgment. The auditor may consider the following factors in applying his or her professional judgment:

- The assessment of audit risk
- The assessment of materiality
- The evidence obtained from other auditing procedures
- The amount of expenditures for the program
- The diversity or homogeneity of expenditures for the program
- The length of time that the program has operated, or changes in its conditions
- The current and prior auditing experience with the program, particularly findings in previous audits and other evaluations (such as inspections, program reviews, or system reviews required by the Federal Acquisition Regulations found in Part 41 of the *Code of Federal Regulations*)
- The extent to which the program is carried out through subrecipients, as well as the related monitoring activities
- The extent to which the program contracts for goods or services
- The level to which the program already is subject to program reviews or other forms of independent oversight
- The expectation of noncompliance or compliance with the direct and material compliance requirements
- The extent to which computer processing is used to administer the program, as well as the complexity of the processing
- Whether the program has been identified as being higher risk by the OMB in the *OMB Circular A-133 Compliance Supplement (Compliance Supplement)*

Audit Risk Considerations

10.06 To express an opinion on compliance, the auditor accumulates sufficient appropriate audit evidence in support of compliance, thereby limiting audit risk to an appropriately low level. The auditor's consideration of audit risk and materiality when planning and performing a single audit is similar to the consideration in a financial statement audit in accordance with AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1). That is, audit risk and materiality, among other matters, need to be considered together for each major program being tested as well as for each direct and material compliance requirement in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. See chapter 6, "Planning Considerations of Circular A-133" for a discussion of audit risk considerations, including a detailed description of the components of audit risk.

Materiality Considerations

10.07 As discussed in chapter 6 of this guide, the auditor's consideration of materiality in a compliance audit differs from that in an audit of the financial statements. Materiality is affected by (a) the nature of the compliance requirements, which may or may not be quantifiable in monetary terms; (b) the nature and frequency of noncompliance identified with an appropriate consideration of sampling risk; and (c) qualitative considerations, such as the needs and expectations of federal agencies and pass-through entities. Qualitative factors that indicate that an identified instance of noncompliance may be immaterial include (a) a low risk of public or political sensitivity; (b) a single exception that has a low risk of being pervasive; or (c) an indication, based on the auditor's judgment and experience, that the affected federal agency or pass-through entity normally would not need to resolve the finding or take follow-up action.

Materiality Judgments About Compliance Applied to Each Major Program Taken as a Whole

10.08 In designing audit tests and developing an opinion on the auditee's compliance with compliance requirements, the auditor should apply the concept of materiality to each major program taken as a whole, rather than to all major programs combined.

10.09 For purposes of evaluating the results of compliance testing, a material instance of noncompliance is defined as a failure to follow requirements, or a violation of prohibitions, established by law, regulation, contract, or grant agreement that results in an aggregation of noncompliance (that is, the auditor's best estimate of the overall noncompliance) that is material to the affected federal program. Instances of noncompliance that may not be individually material should be assessed to determine if, in the aggregate, they could have a material effect. Because the auditor expresses an opinion on each major program and not on all the major programs combined, reaching a conclusion about whether the instances of noncompliance (either individually or in the aggregate) are material to a major program requires consideration of the type and nature of the noncompliance, as well as the actual and projected effect on each major program in which the noncompliance was noted. Instances of noncompliance that are material to one major program may not be material to a major program

of a different size or nature. In addition, the level of materiality relative to a particular major program can change from one audit to the next.

Effect of Material Noncompliance on the Financial Statements

10.10 If the tests of compliance reveal material noncompliance at the major program level, the auditor should consider its effect on the financial statements. The auditor also should consider the cumulative effect of all instances of noncompliance on the financial statements using the materiality level established for the basic financial statements.¹ (See also paragraph 10.51 and chapter 12 of this guide.)

Performing a Compliance Audit

10.11 The auditor should exercise (a) due care in planning and performing the audit and in evaluating the results of his or her audit procedures, and (b) a proper degree of professional skepticism to achieve reasonable assurance that material noncompliance will be detected.

10.12 In a compliance audit, the auditor should perform the following, as discussed in paragraphs 10.13–.65:

- a. Identify the auditee's major programs to be tested and reported on for compliance
- b. Identify the applicable compliance requirements for each major program
- c. Determine which of the applicable compliance requirements identified in step b could have a direct and material effect on each major program
- d. Plan the engagement
- e. Consider relevant portions of the entity's internal control over compliance for each direct and material compliance requirement for each major programs
- f. Obtain sufficient appropriate audit evidence, which involves testing internal control and compliance with applicable compliance requirement for each major program
- g. Consider indications of abuse
- h. Consider subsequent events
- i. Form an opinion about whether the auditee complied with the direct and material compliance requirements
- j. Perform follow-up procedures on previously identified findings

Identifying Major Programs to Be Tested

10.13 Circular A-133 states that the auditor should determine the major programs to be tested in a single audit using a risk-based approach, applying a specific process established in the circular. Chapter 8, "Determination of Major

¹ As discussed in the Audit and Accounting Guide *State and Local Governments*, the auditor's consideration of materiality for purposes of planning, performing, evaluating the results of, and reporting on the audit of the financial statements of a state or local government is based on opinion units.

Programs" of this guide discusses the application of the risk-based approach to determine major programs.

Identifying Direct and Material Compliance Requirements

10.14 As discussed in this section, the auditor should determine, after identifying the applicable compliance requirements for each major program, the direct and material compliance requirements to be tested and reported on in a single audit. As further described in paragraph 10.16, Part 2 of the *Compliance Supplement* provides a matrix that is useful to the auditor in identifying whether particular compliance requirements may apply to federal programs. The auditor then assesses, based on the nature of the program and the transactions for the period under audit, those applicable compliance requirements that may have a direct and material effect on each major program. The auditor should use professional judgment in making this determination.

Compliance Supplement

10.15 The *Compliance Supplement* is based on the requirements of the Single Audit Act Amendments of 1996 (the Single Audit Act) and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. (Chapter 5, "Overview of the Single Audit Act, Circular A-133, and the *Compliance Supplement*," discusses the *Compliance Supplement* and how to obtain it.) The *Compliance Supplement* is a comprehensive source of information regarding compliance. Part 1 of the Compliance Supplement includes background, purpose, and applicability information and Part 2 provides a matrix of applicable compliance requirements. Part 3 of the *Compliance Supplement* identifies the 14 types of compliance requirements applicable to most federal programs, as listed in paragraph 10.16. Part 4 of the *Compliance Supplement* includes a discussion of the compliance requirements specific to certain of the largest federal programs and Part 5 contains information on clusters of programs. Part 6 of the *Compliance Supplement* discusses internal control as it relates to the compliance requirements. As further discussed in paragraph 10.24, Part 7 of the *Compliance Supplement* provides guidance to assist the auditor in identifying the compliance requirements for federal programs not included in the *Compliance Supplement*.

Fourteen Types of Compliance Requirements

10.16 Part 3 of the *Compliance Supplement* lists and describes the 14 types of compliance requirements and the related audit objectives that the auditor should consider in every audit conducted in accordance with Circular A-133, with the exception of program-specific audits performed in accordance with a federal agency's program specific audit guide (see chapter 13). It also provides suggested audit procedures to assist the auditor in planning and performing tests of the auditee's compliance with the requirements of federal programs. The auditor's judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objectives and whether additional or alternative audit procedures are needed (see paragraph 10.40). The 14 types of compliance requirements are as follows:

- A—Activities allowed or unallowed
- B—Allowable costs/cost principles
- C—Cash management
- D—Davis-Bacon Act

- E—Eligibility
- F—Equipment and real property management
- G—Matching, level of effort, earmarking
- H—Period of availability of federal funds
- I—Procurement and suspension and debarment
- J—Program income
- K—Real property acquisition and relocation assistance
- L—Reporting
- M—Subrecipient monitoring
- N—Special tests and provisions

The auditor should consider the applicability of these compliance requirements to the auditee's major programs. Part 2 of the *Compliance Supplement* provides a matrix that is useful to the auditor for this purpose; that matrix identifies whether particular compliance requirements may apply to the federal programs included in the *Compliance Supplement*. In making a determination not to test a compliance requirement identified as applicable to a particular program, the auditor should conclude, and document such conclusion, either that the requirement does not apply to the particular auditee or that noncompliance with the requirements could not have a direct and material effect on a major program. For example, a federal program may be designed such that it potentially may be used to purchase real property, among other things, and thus the matrix in Part 2 of the *Compliance Supplement* would identify the real property acquisition and relocation assistance compliance requirement as applicable. However, the auditee may not have expended any, or expended only an immaterial amount, of their federal program funds on real property and thus the auditor may determine that the real property acquisition and relocation assistance compliance requirement would not be direct or material (even though it was identified as applicable in the Part 2 matrix). No testing would be required on compliance requirements not considered direct and material, but the auditor's conclusion relating to this determination should be documented.

Keeping Abreast of Changes in Compliance Requirements

10.17 Circular A-133 states that an audit of the compliance requirements related to federal programs contained in the *Compliance Supplement* will meet the requirements of the circular. However, it also states that when there have been changes to the compliance requirements and the changes are not reflected in the *Compliance Supplement*, the auditor should determine the current compliance requirements and modify the audit procedures accordingly.

10.18 Although Circular A-133 provides that federal agencies are responsible for informing the OMB annually of any updates needed to the *Compliance Supplement*, laws and regulations change periodically and delays will occur between such changes and revisions to the *Compliance Supplement*. Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current. Besides describing the compliance requirements, the *Compliance Supplement* includes references to the Code of Federal Regulations and other sources of information about the requirements. The auditor may refer to those other sources of information to identify significant changes to the requirements or perform other procedures, including the following:

- Hold discussions with appropriate individuals within the auditee organization (that is, the chief financial officer, internal auditors, legal counsel, compliance officer, or grant or contract administrators)
- Review contracts or grant agreements, new guidance material issued by the granting agency or pass-through entity (for example, handbooks and operating procedures), and correspondence from the granting agency or pass-through entity
- Make inquiries of granting agency personnel (A listing of federal agency contacts, including addresses, phone numbers, and e-mail or Internet site addresses can be found in the *Compliance Supplement's* appendix III.)

Considering Additional Provisions of Contracts or Grant Agreements

10.19 The *Compliance Supplement* states that in addition to the compliance requirements identified in the supplement, auditors should consider whether there are any provisions of contracts or grant agreements that are unique to a particular entity. For example, the grant agreement may specify the matching percentage, or an entity may have agreed to additional requirements that are not required by law or regulation, perhaps as part of a resolution of prior audit findings.

10.20 Therefore, in using the *Compliance Supplement* to identify direct and material compliance requirements, the auditor should consider

- a. the applicability to the federal program of the 14 types of compliance requirements identified in part 3 of the *Compliance Supplement*.
- b. additional compliance requirements specific to the federal program as identified in part 4 of the *Compliance Supplement*.
- c. any provisions of contracts or grants that are unique to the particular entity.

Compliance Requirements Specific to Certain Federal Programs

10.21 Part 4 of the *Compliance Supplement* discusses program objectives, program procedures, and compliance requirements that are specific to each federal program included. With the exception of special tests and provisions, part 3 of the *Compliance Supplement* identifies the audit objectives and suggested audit procedures that pertain to the compliance requirements associated with each program. Because special tests and provisions are unique to each program, part 4 of the *Compliance Supplement* includes those compliance requirements and the related audit objectives and suggested audit procedures. (Part 4 of the *Compliance Supplement* is considered a supplement to part 3 and is not a replacement for it.)

Compliance Requirements Specific to a Cluster of Programs

10.22 As discussed in chapter 5 of this guide, a cluster of programs is a grouping of closely related programs that have similar compliance requirements (for example, Student Financial Assistance (SFA), research and development (R&D), and other clusters). Part 5 of the *Compliance Supplement* identifies those programs that OMB considers clusters of programs. It also provides compliance requirements, audit objectives, and suggested audit procedures

for the SFA and R&D clusters. (States also may designate clusters of programs for federal awards they provide to subrecipients when those awards are for groupings of closely related programs that have similar compliance requirements.)

Relationship of the Compliance Supplement to Federal Program Audit Guides

10.23 The *Compliance Supplement* states that for single audits, the supplement replaces federal agency audit guides and other audit requirement documents for individual federal programs.² Accordingly, for a federal program included in the *Compliance Supplement* and having a separate federal program audit guide or other federal program audit requirement documents, the auditor needs to consider only those compliance requirements in the *Compliance Supplement* when performing a single audit (versus a program-specific audit).

Federal Programs Not Included in the Compliance Supplement

10.24 The *Compliance Supplement* does not include all federal programs from which an auditee may receive federal awards. Circular A-133 states that for those federal programs not covered in the *Compliance Supplement*, the auditor should use the 14 types of compliance requirements (see paragraph 10.16) contained in the supplement as guidance for identifying the types of compliance requirements to test, and should determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements. The auditor should follow the guidance in part 7 of the *Compliance Supplement* for identifying the direct and material compliance requirements to test and report on in a single audit. That guidance outlines the following steps to determine which compliance requirements to test:

- a. Identify the applicable compliance requirements for the federal program.
- b. Determine which of the compliance requirements identified in step a could have a direct and material effect on the major program.
- c. Determine which of the compliance requirements identified in step b are susceptible to testing by the auditor.
- d. Determine which of the 14 types of compliance requirements the compliance requirements identified in step c fall into.
- e. For special tests and provisions, determine the applicable audit objectives and audit procedures.

Part 7 of the *Compliance Supplement* provides more detailed guidance on the steps to perform to identify direct and material compliance requirements.

² Some federal agencies have developed audit guides or supplements related to their programs. For programs not listed in the *OMB Circular A-133 Compliance Supplement (Compliance Supplement)*, the auditor may wish to consider that guidance in identifying the program objectives, program procedures, and compliance requirements, as suggested in part 7 of the *Compliance Supplement*. That guidance, where available, may be obtained from the federal agency's Office of Inspector General. Auditors should consider whether such guidance might not be up-to-date with regard to compliance requirements or current authoritative auditing standards and requirements and the discussion about such situations in chapter 13, "Program-Specific Audits," of this guide.

Planning the Engagement

General Considerations

10.25 Planning a compliance audit involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, auditors need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on compliance. Proper planning and supervision contribute to the effectiveness of audit procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied. (See also chapter 6 of this guide.)

10.26 Factors the auditor might consider in planning a compliance audit include (a) the anticipated level of audit risk related to the compliance requirements on which the auditor will report (see paragraph 10.06), (b) preliminary judgments about materiality levels for audit purposes (see paragraphs 10.07–.10), and (c) conditions that may require the extension or modification of audit procedures.

10.27 The nature, timing, and extent of planning will vary with the nature and complexity of the compliance requirements and the auditor's prior experience with the auditee. The auditor must plan the audit so that it is responsive to the assessment of the risks of material noncompliance based on the auditor's understanding of the entity and its environment, including its internal control. As the compliance audit progresses, changed conditions may make it necessary to modify planned procedures. Chapter 6 of this guide discusses additional planning considerations.

Multiple-Component Considerations

10.28 In a compliance audit in which the auditee has operations in multiple organizational units (for example, locations or branches), the auditor may determine that it is not necessary to test compliance with requirements at every such unit. Making such a determination and selecting the units to be tested includes consideration of the following factors: (a) the degree to which the specified compliance requirements apply at the organizational unit; (b) judgments about materiality; (c) the degree of centralization of the records; (d) the effectiveness of controls, particularly those that affect management's direct control over the exercise of authority delegated to others, as well as its ability to supervise activities at various locations effectively; (e) the nature and extent of operations conducted at the various organizational units; and (f) the similarity of operations and controls over compliance for different organizational units. Chapters 8 and 9 "Internal Control Over Compliance for Major Programs" of this guide discuss other multiple-organizational unit considerations.

Consideration of Internal Control Over Compliance for Major Programs

10.29 For each of the direct and material compliance requirements for each major program, the auditor should obtain an understanding of relevant portions of internal control over compliance sufficient to plan the audit and to assess control risk for compliance with those requirements. In planning the audit, the auditor should use this knowledge to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance,

and to design appropriate tests of compliance. Circular A-133 specifically states that the auditor should perform procedures to obtain an understanding of internal control over compliance for federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. Circular A-133 also states that the auditor should perform testing of controls as planned. In some instances, the auditor may be able to perform compliance testing for major programs concurrently with tests of controls. (Chapter 6 of this guide discusses how to develop an efficient audit approach.) Any significant deficiencies in internal control over compliance for major programs that are noted should be reported as an audit finding. (Chapter 12 of this guide discusses the situations that Circular A-133 requires the auditor to report as audit findings.) Chapter 6 of this guide further discusses control risk, and chapter 10 of this guide discusses the auditor's consideration of internal control over compliance for major programs, including the final control risk assessment and the performance of tests of controls.

Performing Compliance Testing

10.30 In planning the audit, the auditor should use knowledge gained in the inherent risk assessment process (as described in chapter 6 of this guide) to (1) identify types of potential noncompliance, (2) to consider other factors that affect the risk of material noncompliance, and (3) to design appropriate tests of compliance so as to reduce the risk of significant noncompliance to a sufficiently low level.

10.31 As described in chapter 9 of this guide, Circular A-133 specifically requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. This includes performing procedures to evaluate the design and operating effectiveness of the internal control over compliance for each direct and material compliance requirement for each major program. In some instances, the auditor may be able to perform compliance testing for major programs concurrently with tests of controls (that is, dual purpose testing). However, such internal control and compliance tests should be distinguished from each other so that there is clear documentation to support both controls and compliance testing and the separate conclusions reached on both the internal control aspects of the population tested and also the related compliance.

10.32 Circular A-133 states that compliance testing should include tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program. Such compliance testing may be performed (a) concurrently with tests of controls, (b) as substantive testing, or (c) as a combination of the two. In performing compliance testing, the auditor attempts to obtain reasonable assurance that the auditee complied, in all material respects, with the compliance requirements. This includes designing the compliance audit to detect both intentional and unintentional noncompliance. Absolute assurance is not attainable because of factors such as the need for judgment, the use of sampling, and the inherent limitations of internal control over compliance and because much of the evidence available to the auditor is persuasive rather than conclusive in nature. Further, procedures that are effective for detecting unintentional noncompliance may be ineffective for detecting noncompliance that is intentional and is concealed through collusion between the auditee's personnel and third parties or among the auditee's management or other employees.

Therefore, the subsequent discovery that material noncompliance exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

10.33 In determining the nature, timing, and extent of tests to perform, the auditor should exercise professional judgment regarding the appropriate level of detection risk to accept. In applying judgment, be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient appropriate evidence. (Paragraphs 10.41–44 further discuss audit sampling.) In determining the nature, timing, and extent of the testing of an auditee's compliance with compliance requirements, the auditor should consider both audit risk and materiality related to each major program as well as for each direct and material compliance requirement related to each major program. The auditor plans compliance tests to reduce detection risk to an acceptable level. The evidence provided by those tests, along with evidence regarding inherent risk and control risk, provides the basis for expressing an opinion on whether the auditee complied, in all material respects, with the direct and material compliance requirements for each major program.

10.34 In determining the nature of tests of compliance with requirements governing major programs, the consideration of the nature of those requirements will assist the auditor. For example, to test compliance with requirements applicable to the allowability of expenditures using program funds, the auditor should design audit procedures to provide sufficient appropriate audit evidence to evaluate how management expended the funds.

Sufficient Appropriate Audit Evidence

10.35 The auditor should apply procedures to provide reasonable assurance of detecting material noncompliance. The selection and application of procedures that will accumulate evidence that is sufficient and appropriate in the circumstances to provide a reasonable basis for expressing an opinion on compliance require the careful exercise of professional judgment. A broad array of available procedures may be applied in a compliance audit. In establishing a proper combination of procedures to restrict audit risk appropriately, the auditor should consider the following generalizations, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

- a.* Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.
- b.* Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
- c.* Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, in-inquiry about the application of a control).
- d.* Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- e.* Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

10.36 Thus, in the hierarchy of available audit procedures, those that involve search and verification (for example, inspection, confirmation, or observation)—particularly when independent sources outside the entity are used—generally are more effective in reducing audit risk than are those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with the individuals responsible for compliance).

10.37 In a compliance audit, the auditor's objective is to accumulate sufficient appropriate audit evidence to limit audit risk to a level that is, in the auditor's professional judgment, appropriately low for the high level of assurance being provided. An auditor should select from all available procedures (that is, procedures that assess inherent, control, and fraud risk and restrict detection risk) any combination that can limit audit risk to such an appropriately low level.

10.38 For regulatory requirements, the auditor's procedures may include reviewing reports of significant examinations and related communications between regulatory agencies and the entity and, when appropriate, making inquiries of the regulatory agencies, including inquiries about examinations in progress.

Audit Objectives

10.39 As noted in paragraph 10.16, the *Compliance Supplement* contains the audit objectives for each type of compliance requirement that the auditor should consider in planning and performing tests of compliance requirements. The audit objectives are useful in understanding the specific objectives to be satisfied when the auditor performs audit tests and determines whether the noncompliance that is identified is material.

Suggested Audit Procedures

10.40 The *Compliance Supplement* contains suggested audit procedures for testing federal programs for compliance. Those suggested audit procedures represent procedures that may be used by the auditor in developing an audit program. The suggested audit procedures also may be useful in testing the same types of compliance requirements for programs that are not included in the *Compliance Supplement*. The auditor should use professional judgment in determining the audit procedures to be performed to allow him or her to obtain sufficient appropriate audit evidence to form an opinion on the auditee's compliance with the compliance requirements that could have a direct and material effect on each major program.

Audit Sampling

10.41 The auditor generally uses audit sampling to obtain audit evidence. There are two approaches to audit sampling: nonstatistical and statistical. Circular A-133 does not require any particular sampling approach in a single audit. AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1), discusses the factors to be considered in planning, designing, and evaluating audit samples, including planning a particular sample for a test of controls. When planning to test a particular sample of transactions, the auditor should consider the specific audit objective to be achieved and should determine that

the audit procedure, or combination of procedures, to be applied will achieve that objective. The size of a sample necessary to provide sufficient appropriate audit evidence depends on both the objectives and the efficiency of the sample. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the planned level of detection risk, tolerable misstatement, expected misstatement, and nature of the population. However, as noted in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, (AICPA, *Professional Standards*, vol. 1), the auditor should also consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population as opposed to performing sampling or stratifying the population into homogeneous sub-populations for sampling. AU section 350 contains additional guidance on the use of sampling and other means of selecting items for testing.

10.42 AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1), and Circular A-133 state that the auditor should determine both the known questioned costs and likely questioned costs associated with audit findings. The determination of likely questioned costs may require the projection of sample results to determine whether a finding should be reported in the schedule of findings and questioned costs. The auditor is not required to expand his or her testwork to definitively determine the total questioned costs. Circular A-133 does not require the auditor to report an exact amount or a statistical projection of likely questioned costs, but rather to include an audit finding when the auditor's estimate of likely questioned costs is greater than \$10,000. Paragraph 10.58 further discusses likely questioned costs.

10.43 The AICPA Audit Guide *Audit Sampling* provides guidance to help auditors apply audit sampling in accordance with AU section 350. That guide discusses sampling in compliance tests of internal controls and in substantive tests of details, as well as dual-purpose testing.

Using Separate Samples for Each Major Program

10.44 Although the auditor is required to obtain sufficient appropriate audit evidence to support an opinion on compliance for each major federal program, separate samples for each major program are not required. Experience has shown, however, that it is preferable to select separate samples from each major program because the separate sample provides clear 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 auditor should prepare the audit documentation such that it clearly indicates that the results of such samples, together with other audit evidence, are sufficient to support the opinion on each major program's compliance. As noted in paragraph 10.33, a sample of a few items with a low dollar value and from a large population generally does not, by itself, provide sufficient appropriate evidence.

Consideration of Abuse

10.45 As discussed in chapter 3 of this guide, paragraphs 4.10–.13 of *Government Auditing Standards* discuss its additional fieldwork standard that requires auditors to be alert to situations or transactions that could be indicative

of abuse.³ Because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse. However, if auditors become aware of indications of abuse that could be quantitatively or qualitatively material to the financial statement amounts, they should apply audit procedures specifically directed to ascertain whether abuse has occurred and the potential effect on the financial statement amounts or other financial data significant to the audit objectives. That standard, like all of the general, fieldwork, and reporting standards in *Government Auditing Standards*, applies to the entirety of the A-133 audit, including the compliance audit. Therefore, if in performing procedures on major programs, the auditor becomes aware of a situation or transaction that might constitute abuse, the auditor should extend procedures to determine whether it is indicative of abuse and potentially material to the financial statement amounts⁴ or to the major program. (Chapter 3 of this guide further discusses procedures relating to and the evaluation of indications of abuse.) Because the OMB cost principles circulars require that costs charged to federal awards be reasonable and necessary for the performance and administration of the awards,⁵ situations or transactions involving federal awards that might otherwise appear to constitute abuse instead generally are instances of noncompliance. (By definition, instances of noncompliance—illegal acts and violations of provisions of contracts or grant agreements—are not abuse.) However, there may be isolated situations or transactions involving federal awards that the auditor becomes aware of that do constitute abuse. Chapter 12 of this guide discusses the reporting of abuse involving federal awards.

Consideration of Subsequent Events

10.46 The auditor's consideration of subsequent events in a compliance audit is similar to the auditor's consideration of subsequent events in a financial statement audit, as outlined in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), except that the events under consideration relate to the direct and material compliance requirements after the end of the audit period and through the date of the auditor's report. Two types of subsequent events require consideration by management and evaluation by the auditor.

10.47 The first type consists of events that provide additional information about the entity's compliance during the audit period. For the period from the end of the audit period to the date of the auditor's report, the auditor should perform procedures to identify such events. Those procedures generally should include, but may not be limited to, inquiries about and consideration of the following information:

- Relevant internal auditors' reports issued during the subsequent period

³ Paragraph 4.12 of *Government Auditing Standards* describes "abuse" by stating that it is distinct from fraud, illegal acts, and violations of provisions of contracts or grant agreements. Abuse, it states, "involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances."

⁴ See footnote 1 at paragraph 10.10.

⁵ This compliance requirement is explained in part 3, "Compliance Requirements," of the *Compliance Supplement*, Section B, "Allowable Costs/Cost Principles."

- Other auditors' reports identifying noncompliance that were issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance that were issued during the subsequent period
- Information about the entity's noncompliance, obtained through other professional engagements for that entity

10.48 The second type of subsequent events consists of noncompliance that occurs subsequent to the audit period but before the date of the auditor's report. These events would not result in findings of noncompliance for the current year under audit. The auditor has no responsibility to detect such noncompliance. However, should such noncompliance come to the auditor's attention, it may be of such a nature and significance that the auditor should consider whether the matter is adequately disclosed in the notes to the schedule of expenditures of federal awards.

Evaluation and Reporting of Noncompliance

Instances of Noncompliance (Findings)

10.49 The auditor's tests of compliance with compliance requirements may disclose instances of noncompliance. Circular A-133 refers to these instances of noncompliance, among other matters, as "findings." Such findings may be of a monetary nature and involve questioned costs or may be nonmonetary and not result in questioned costs. Both *Government Auditing Standards* and Circular A-133 specify how certain findings are to be reported. Chapter 12 of this guide discusses the auditor's opinion on compliance and his or her responsibilities for reporting findings.

Compliance Opinion

10.50 Circular A-133 states that the auditor should report on compliance, which includes an opinion or disclaimer of opinion on each major program on whether the auditee complied with the direct and material compliance requirements, and to prepare a schedule of findings and questioned costs. (Chapter 12 of this guide discusses that report and schedule.) In evaluating whether the auditee complied with the compliance requirements in all material respects, consideration is given to (a) the nature and frequency of the noncompliance identified, and (b) whether such noncompliance is material relative to the nature of the compliance requirements. Assessing materiality at the appropriate level is critical to the proper evaluation of findings. Paragraphs 10.07–10 discuss materiality as it relates to expressing an opinion on the auditee's compliance. Paragraph 10.53 discusses the auditor's evaluation of the effect of questioned costs on the compliance opinion.

Financial Statement Effect

10.51 The auditor also has the responsibility of assessing the effect of the actual and likely error noted in the single audit against the materiality level established for the basic financial statements (see paragraph 10.10). Consideration of the effect of the following items is part of this evaluation: (a) any contingent liability that may arise from the noncompliance in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, or GASB Statement No. 33, *Accounting and Financial Reporting*

for *Nonexchange Transactions*, as amended, as applicable,⁶ and (b) for non-governmental entities, any uncertainty regarding the resolution of instances of noncompliance in accordance with Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640).

Questioned Costs

10.52 Circular A-133 defines questioned costs to include costs that are questioned by the auditor because of an audit finding (a) that resulted from a violation or possible violation of a provision of a law, regulation contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds; (b) for which the costs, at the time of the audit, are not supported by adequate documentation; or (c) for which the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Evaluating the Effect of Questioned Costs on the Compliance Opinion

10.53 In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of the total costs questioned for each major program (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). There may be situations in which the known questioned costs are not considered material but the likely questioned costs are considered material. In those situations, the auditor should consider the noncompliance to be material (and report a finding) or may expand the scope of the audit and apply additional audit procedures to further establish the likely questioned costs.

Federal Agency Consideration of Findings and Questioned Costs

10.54 The auditor's designation of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances, the auditor is unable to determine whether a federal awarding agency or pass-through entity will ultimately disallow a questioned cost, because the agency or entity has considerable discretion in those matters.

10.55 Circular A-133 defines a management decision as the evaluation by the federal awarding agency or pass-through entity of the audit findings and corrective action plan and the issuance of a written decision about what corrective action is necessary. (Chapter 12 of this guide discusses the corrective action plan.) Circular A-133 allows a federal awarding agency or pass-through entity receiving an auditor's report indicating findings and questioned costs six months after receipt of the audit report to issue such a decision. The awarding agency or pass-through entity considers the nature of the questioned costs, as well as the amounts involved, in issuing a management decision and deciding whether to disallow them. In addition, most federal awarding agencies have established appeal and adjudication procedures for questioned costs. Because of the discretion allowed in resolving these matters, all questioned costs are subject to uncertainty regarding their resolution.

⁶ GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, as amended, provides standards for the recognition and reporting of refunds of nonexchange revenues by a state or local government when the government does not meet a provider's requirements. FASB Statement No. 5, *Accounting for Contingencies*, applies to governmental entities for certain other types of contingencies and to nongovernmental entities.

Reporting the Findings

10.56 As discussed in chapter 6 of this guide, Circular A-133 states that the auditor should consider a different level of materiality for the purposes of reporting audit findings. Circular A-133 states that the auditor, in addition to providing an opinion on compliance, should include the following, among other items, in the schedule of findings and questioned costs:

- Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement*.
- Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program. (Paragraph 10.16 lists the 14 types of compliance requirements.) Known questioned costs are those specifically identified by the auditor.
- Known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement.
- Known questioned costs that are greater than \$10,000 for a federal program that is not audited as a major program.

Chapter 12 of this guide discusses the reporting of audit findings and contains a complete listing of the items that Circular A-133 requires to be reported in the schedule of findings and questioned costs. That chapter also discusses the requirement from paragraph 5.16 of *Government Auditing Standards* that the auditor communicate to the auditee in writing violations of provisions of contracts or grant agreements that are more than inconsequential but less than material.⁷

Findings of Noncompliance That Cannot Be Quantified

10.57 The auditor may discover instances of noncompliance that cannot be quantified. The auditor's responsibility for reporting such findings can best be described through an example. Assume that the auditor encounters a pass-through entity that consistently fails to provide its subrecipients with federal award information. Circular A-133 requires the auditor to consider noncompliance findings in relation to a type of compliance requirement (in the example provided, subrecipient monitoring is the relevant type of compliance requirement) or an audit objective identified in the *Compliance Supplement*. The pertinent audit objective included in the *Compliance Supplement* and relating to the example provided here is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient." Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance would be material in relation to the audit objective and, therefore, should be reported

⁷ Generally, *Government Auditing Standards* requires the auditor to evaluate findings for the purpose of required communications based on their consequence to the financial statements or other financial data significant to the audit objectives. As discussed in chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide, however, in an audit in accordance with Circular A-133, the auditor should evaluate findings involving federal awards for the purpose of that communication based only on their consequence to the financial statements.

as an audit finding. In addition, the auditor also should consider whether significant deficiencies exist and require reporting with respect to subrecipient monitoring.

Reporting Based on Likely Questioned Costs

10.58 As noted in paragraph 10.43, in evaluating the effect of questioned costs on the opinion on compliance, the auditor considers both known questioned costs and the best estimate of the total costs questioned (likely questioned costs). Known and likely questioned costs also need to be considered when audit findings are reported. In addition to reporting known questioned costs greater than \$10,000 for a type of compliance requirement for a major program in the schedule of findings and questioned costs, the auditor also should report known questioned costs when likely questioned costs for a type of compliance requirement for a major program are greater than \$10,000. For example, if the auditor specifically identifies \$7,000 in questioned costs for a type of compliance requirement for a major program but, based on his or her evaluation of the effect of questioned costs for that compliance requirement estimates that the total questioned costs are in the \$50,000 to \$60,000 range, the auditor would report a finding that indicates the known questioned costs of \$7,000. Chapter 12 of this guide further discusses reporting findings based on likely questioned costs.

Performing Follow-Up Procedures

Auditee Responsibilities for Audit Follow-Up and for the Summary Schedule of Prior Audit Findings⁸

10.59 Circular A-133 states that the auditee is responsible for follow-up and corrective action on all audit findings. Part of the follow-up required by Circular A-133 is that the auditee should prepare a summary schedule of prior audit findings. (Chapter 12 of this guide discusses the summary schedule of prior audit findings.) That schedule reports the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It also includes audit findings reported in the prior audit's summary schedule of prior audit findings that were not identified as either (a) fully corrected, (b) no longer valid, or (c) not warranting further actions. Circular A-133 states that a valid reason for considering an audit finding as not warranting further action is that *all* of the following have occurred:

- Two years have passed since the audit report in which the finding occurred was submitted to the federal clearinghouse.
- The federal agency or pass-through entity is not currently following up with the auditee on the audit finding.
- A management decision was not issued.

10.60 Circular A-133 also states the following with regard to the auditee's schedule of prior audit findings:

- When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.

⁸ Chapter 2, "Planning Considerations of *Government Auditing Standards*," of this guide discusses the auditee's responsibilities under *Government Auditing Standards* for audit follow-up.

- When audit findings were not fully corrected or were only partially corrected, the summary schedule should describe the planned corrective action as well as any partial corrective action taken.
- When the corrective action taken is significantly different from the corrective action previously reported in a corrective action plan or in the federal agency's or pass-through entity's management decision, the summary schedule should provide an explanation.
- When the auditee believes the audit findings are no longer valid or do not warrant further actions, the reasons for this position should be described in the summary schedule, as discussed in paragraph 10.59.

Auditor Responsibilities for Follow-Up on Previously Reported Findings

10.61 Circular A-133 states that the auditor should follow up on prior audit findings, perform procedures to assess the reasonableness of the schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor should perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year. Chapter 12 of this guide further discusses the auditor's reporting responsibilities.

Auditor Follow-Up Procedures

10.62 To follow up on previous audit findings, the auditor should obtain the auditee's summary schedule of prior audit findings and perform appropriate procedures on that information. Although in many cases the procedures performed in the current audit will provide a basis for the auditor to assess the schedule, the auditor may find it necessary to perform procedures directed specifically at the status of prior audit findings. In these cases, consideration might include the following procedures:

- Make inquiries of auditee management and program personnel, including inquiries about the status of corrective actions and the estimated completion date for incomplete actions
- Review management decisions issued by federal awarding agencies or pass-through entities to the auditee (paragraph 10.55 discusses management decisions)
- Observe an activity that has been redesigned to address a prior-year finding
- Test similar current-year transactions

Audit Follow-Up for Findings Reported Under Government Auditing Standards

10.63 As discussed in chapter 2, "Planning Considerations of *Government Auditing Standards*," of this guide, *Government Auditing Standards* establishes an additional fieldwork standard that states the auditor should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements. The auditee's schedule of prior audit findings prepared as required by Circular A-133 includes only the status of certain prior-year findings relative to federal awards. *Government*

Auditing Standards does not require the auditor to report the status of prior audit findings reported under *Government Auditing Standards* in a written report. However, there may be certain financial statement audit findings that were reported in the prior period under *Government Auditing Standards* that are also included in the summary schedule of prior audit findings (because they also relate to federal awards). Although not required, some auditees may decide to include the status of other financial statement audit findings (that is, those that are not related to federal awards) in the schedule.

Corrective Action Plan

10.64 Circular A-133 also requires that upon completion of the audit, the auditee should prepare a corrective action plan that identifies the contact person responsible for corrective action and indicates the corrective action planned for each audit finding (referred to by the auditor assigned reference number) and the anticipated completion date. If the auditee does not agree with a finding, the corrective action plan should contain an explanation and specific reasons why the auditee disagrees. The auditor may find the auditee's corrective action plan useful in performing audit follow-up (in addition to the auditee's summary schedule of prior audit findings) because it may provide a preliminary indication of the corrective steps planned by the auditee. (See also the discussions in chapters 4 and 12 concerning the *Government Auditing Standards* requirement that the auditor obtain and report the views of responsible officials concerning findings, conclusions, and recommendations, as well as planned corrective actions.)

Disputes or Unresolved Findings

10.65 There may be times when, as part of the follow-up on prior findings, the auditor determines that (a) a previous finding is the subject of a dispute between the auditee and the federal awarding agency or pass-through entity or (b) the federal awarding agency or pass-through entity has not addressed the finding by issuing a management decision. In these situations, if the finding relates to a current-year major program, this guide recommends that the auditor report similar transactions of the current year as findings and questioned costs until either the dispute is resolved or the initial finding no longer warrants further action under Circular A-133 as described in paragraph 10.59. However, if the auditor no longer believes that there is noncompliance because of additional evidence obtained in the current year, similar transactions need not be reported as findings.

Management Representations Related to Federal Awards

10.66 As part of an audit under Circular A-133, the auditor should obtain written representations from management about matters related to federal awards. Therefore, in addition to the management representations obtained in connection with an audit of the financial statements as discussed in chapter 3 of this guide, the auditor should obtain written representations from management concerning the identification and completeness of federal award programs, representations concerning compliance with compliance requirements, and identification of known instances of noncompliance. Paragraph 10.67 contains a suggested listing of representations. Chapter 3 discusses the members of management and other officials from whom the auditor should consider obtaining representations. In a Circular A-133 audit, the auditor also should

consider obtaining representations from officials responsible for managing federal awards.

Suggested Representations

10.67 The auditor should consider obtaining the following written representations in a single audit:^{9,10,11}

- Management is responsible for complying, and has complied, with the requirements of Circular A-133.
- Management has prepared the schedule of expenditures of federal awards in accordance with Circular A-133 and has included expenditures made during the period being audited for all awards provided by federal agencies in the form of grants, federal cost-reimbursement contracts, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance.
- Management is responsible for establishing and maintaining, and has established and maintained, effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on its federal programs.
- Management is responsible for complying with the requirements of laws, regulations, and the provisions of contracts and grant agreements related to each of its federal programs and has complied, in all material respects, with those requirements.
- Management has identified and disclosed to the auditor the requirements of laws, regulations, and the provisions of contracts and grant agreements that are considered to have a direct and material effect on each major program.
- Management had provided to the auditor its interpretations of any compliance requirements that have varying interpretations.
- Management has made available all contracts and grant agreements (including amendments, if any) and any other correspondence that have taken place with federal agencies or pass-through entities related to federal programs.
- Management has identified and disclosed to the auditor all amounts questioned and any known noncompliance with the requirements of federal awards, including those resulting from other audits or program reviews.

⁹ These representations may be added to a representation letter obtained in connection with an audit of the financial statements instead of a separate letter.

¹⁰ As discussed in chapter 6, although the requirements of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), do not apply to a compliance audit, the auditor may want to consider its guidance when planning and performing an audit of an auditee's compliance with specified requirements applicable to its major programs. Consequently, the auditor may wish to obtain management representations concerning fraud or suspected fraud that could have a material effect on compliance with its major programs.

¹¹ The auditor should modify these representations, as appropriate, for different conditions, such as known noncompliance.

- Management has charged costs to federal awards in accordance with applicable cost principles.
- Management has made available all documentation related to the compliance requirements, including information related to federal program financial reports and claims for advances and reimbursements.
- Federal program financial reports and claims for advances and reimbursements are supported by the books and records from which the basic financial statements have been prepared.
- The copies of federal program financial reports provided to the auditor are true copies of the reports submitted, or electronically transmitted, to the federal agency or pass-through entity, as applicable.
- If applicable, management has monitored subrecipients to determine that they have expended pass-through assistance in accordance with applicable laws and regulations and have met the requirements of Circular A-133.
- If applicable, management has issued management decisions timely after their receipt of subrecipients' auditor's reports that identified noncompliance with laws, regulations, or the provisions of contracts or grant agreements, and has ensured that subrecipients have taken the appropriate and timely corrective action on findings.
- If applicable, management has considered the results of subrecipient audits and has made any necessary adjustments to the auditee's own books and records.
- Management is responsible for and has accurately prepared the summary schedule of prior audit findings to include all findings required to be included by Circular A-133.
- Management has provided the auditor with all information on the status of the follow-up on prior audit findings by federal awarding agencies and pass-through entities, including all management decisions.
- Management has accurately completed the appropriate sections of the data collection form.
- If applicable, management has disclosed all contracts or other agreements with service organizations.
- If applicable, management has disclosed to the auditor all communications from service organizations relating to noncompliance at those organizations.
- Management has disclosed any known noncompliance occurring subsequent to the period for which compliance is audited.
- Management has disclosed whether any changes in internal control over compliance or other factors that might significantly affect internal control, including any corrective action taken by management with regard to significant deficiencies (including material weaknesses), have occurred subsequent to the date as of which compliance is audited.

Refusal to Furnish Written Representations

10.68 Management's refusal to furnish all written representations that the auditor considers necessary in the circumstances constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on the auditee's compliance with major program requirements. The auditor also should consider the effects of management's refusal on his or her ability to rely on other management representations.

State and Local Government Compliance Auditing Considerations

10.69 An auditor also may be engaged to test and report on compliance with state and local laws and regulations in addition to the testing and reporting requirements imposed by *Government Auditing Standards* and Circular A-133. Although such auditing is outside the scope of this guide, such a requirement may specify compliance tests, similar to those in a single audit. When this is the case, auditors might consider consulting state or local government officials or other sources concerning the nature and scope of the required testing. (Chapter 6 of this guide briefly discusses compliance audits of state and local grants.) It is important to distinguish state or local government funds from pass-through federal funds because pass-through federal funds are considered part of the federal awards received in an audit in accordance with Circular A-133.

Chapter 11

Audit Considerations of Federal Pass-Through Awards

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (Chapters 2–4 of this guide), discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in part I of this guide in addition to the guidance in part II, "Circular A-133 Audits" (Chapters 5–13 of this guide).

Introduction

11.01 Many nonfederal entities receiving federal awards make pass-through payments of federal awards to other entities that are considered sub-recipients. The amount of those payments may be material to the pass-through entity's financial statements,¹ individual major programs, or both. This chapter discusses the auditor's consideration of pass-through federal awards in an audit of both pass-through entities and subrecipients of federal awards under OMB Circular A-133. It also discusses the auditee's and auditor's responsibilities with respect to activities carried out by vendors. An auditee with multiple federal funding agreements may be a pass-through entity in regard to some awards, a subrecipient in regard to other awards, and a vendor with respect to other agreements.

Definitions

11.02 Circular A-133 includes the following definitions that are relevant to pass-through awards:

- *Federal award*—Federal financial assistance and federal cost-reimbursement contracts that nonfederal entities receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors.
- *Nonfederal entity*—A state, local government, or nonprofit organization (NPO).

¹ As discussed in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor's consideration of materiality for purposes of planning, performing, evaluating the results of, and reporting on the audit of the financial statements of a state or local government is based on opinion units. See that guide for further guidance.

- *Recipient*—A nonfederal entity that expends federal awards received directly from a federal awarding agency to carry out a federal program.
- *Pass-through entity*—A nonfederal entity that provides a federal award to a subrecipient to carry out a federal program.
- *Subrecipient*—A nonfederal entity that expends federal awards received from a pass-through entity to carry out a federal program but does not include an individual who is a beneficiary of such a program. A subrecipient may also be a recipient of other federal awards directly from a federal awarding agency.
- *Vendor*—A dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the federal program.

Applicability of Circular A-133

11.03 Circular A-133 applies to both recipients expending federal awards received directly from federal awarding agencies and subrecipients expending federal awards received from a pass-through entity. Accordingly, both recipients and subrecipients that expend \$500,000 or more in federal awards should have a single or program-specific audit in accordance with Circular A-133. (Chapter 13, "Program-Specific Audits," of this guide discusses program-specific audits.)

11.04 The determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards passed through to subrecipients, the activity that requires the pass-through entity to comply with laws, regulations, and the provisions of contracts or grant agreements is the disbursement of funds to subrecipients. The activity that requires subrecipients to comply with laws, regulations, and the provisions of contracts or grant agreements is the expenditure of the pass-through award.

11.05 Payments received by a vendor for goods or services provided in connection with a federal program are not considered federal awards. Furthermore, Medicaid payments to a subrecipient for providing patient care services to Medicaid-eligible individuals are not considered federal awards expended under Circular A-133 unless a state requires the funds to be treated as federal awards expended because reimbursement is on a cost-reimbursement basis.

11.06 If a pass-through entity provides federal awards to subrecipients, the pass-through entity should monitor the subrecipients' activities to provide reasonable assurance that the subrecipients administer federal awards in compliance with federal requirements. As part of the compliance audit, the auditor of the pass-through entity should test and report on subrecipient monitoring (which is one of the 14 types of compliance requirements in the *OMB Circular A-133 Compliance Supplement (Compliance Supplement)*), as discussed in chapter 10, "Compliance Auditing Applicable to Major Programs," of this guide) when federal awards passed through to subrecipients are material to a major program (see paragraphs 11.24–.35). If the federal awards provided are immaterial to a major program or relate to a program that is not considered major, the auditor of the pass-through entity has no additional compliance auditing responsibilities related to the funds passed through to subrecipients.

11.07 Most of this chapter focuses on compliance auditing considerations for auditors of pass-through entities. However, paragraphs 11.43–47 provide additional considerations for auditors of subrecipients.

Pass-Through Entities, Subrecipients, and Vendors

Subrecipient Status Versus Vendor Status

11.08 The responsibilities for compliance with federal program requirements and the applicable compliance requirements to be tested by the auditor may be significantly different depending on whether the entity is a pass-through entity, subrecipient, or vendor. Section 210 of Circular A-133 provides guidance on distinguishing between a subrecipient and a vendor; paragraphs 11.09–11 summarize that guidance.

Characteristics Indicative of a Federal Award Received by a Subrecipient

11.09 According to Circular A-133, characteristics indicative of a federal award received by a subrecipient are when the entity

- determines who is eligible to receive what federal financial assistance.
- has its performance measured against whether the objectives of the federal program are met.
- has responsibility for programmatic decision making.
- has responsibility for adherence to applicable federal program compliance requirements.
- uses the federal funds to carry out a program of the entity as compared to providing goods or services for a program of the pass-through entity.

Paragraph 11.12 provides examples of the relationship between pass-through entities and subrecipients.

Characteristics Indicative of a Payment for Goods or Services Received by a Vendor

11.10 According to Circular A-133, the characteristics indicative of a payment for goods or services received by a vendor are when the entity

- provides the goods and services within normal business operations.
- provides similar goods or services to many different purchasers.
- operates in a competitive environment.
- provides goods or services that are ancillary to the operation of the federal program.
- is not subject to the compliance requirements of the federal program.

Paragraph 11.13 provides examples of the relationship between pass-through entities and vendors.

Use of Judgment in Determining Subrecipient or Vendor Status

11.11 Circular A-133 states that there may be unusual circumstances or exceptions to the characteristics listed in paragraphs 11.09–10. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present, and judgment should be used in determining whether an entity is a subrecipient or vendor. In some cases, it may be difficult to determine whether the relationship with the entity is that of a subrecipient or of a vendor. The federal cognizant agency for audit, the oversight agency for audit, or the federal awarding agency may be of assistance in making those determinations.

Description of Relationships

Pass-Through Entity and Subrecipient

11.12 Following are examples of a typical relationship between a pass-through entity and a subrecipient:

- A state department of education (pass-through entity) receives a federal award and is responsible for administering and disbursing the federal award to local school districts (subrecipients) according to a formula or on some other basis.
- A regional planning commission (pass-through entity) receives a federal award for the feeding of elderly and low-income individuals, and the award is disbursed to NPOs (subrecipients) to support their feeding programs.
- A hospital (subrecipient) receives a federal award from a university (pass-through entity) to conduct research.
- A theater group (subrecipient) receives a federal award from a state arts commission (pass-through entity) to support a summer arts series.

Recipient and Vendor

11.13 Following are examples of a typical relationship between a recipient and a vendor:

- A local government (recipient) receives a federal award to provide mental health services in a designated area. Some of the funds are paid to a contractor (vendor) to repair a leaking roof.
- A county (recipient) receives a federal award to operate a Head Start program and pays an NPO (vendor) to provide temporary clerical services.
- An NPO (recipient) receives a federal award to run a preschool and pays a medical doctor (vendor) to perform health screening on a per-student basis.
- An NPO (recipient) receives a federal award to operate a child care center and pays a not-for-profit clinic (vendor) to perform physical exams.

Entity Is Both a Subrecipient and a Pass-Through Entity

11.14 There are instances in which an entity can be both a subrecipient and a pass-through entity, as shown in the following examples:

- A local government receives a pass-through federal award from a state government agency (the local government is a subrecipient) and further passes through a portion of the federal award to an NPO (the local government also is a pass-through entity) to administer a federal program.
- An NPO area agency receives a pass-through federal award from a state (the NPO area agency is a subrecipient) and further passes through a portion of the federal award to a for-profit health care provider (the NPO area agency also is a pass-through entity). Paragraph 11.40 discusses a pass-through entity's responsibilities when the subrecipient is a for-profit entity.

Vendor Compliance Considerations

Auditee's Responsibilities

11.15 Circular A-133 states that in most cases, the auditee's compliance responsibility for a vendor is to ensure only that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. A program's compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions that are structured such that the vendor is responsible for program compliance or the vendor's records should be reviewed to determine compliance.

Auditor's Responsibilities

11.16 When vendors are responsible for program compliance, the auditor should determine whether vendor transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements if such transactions are material to a major program of the auditee. In such a case, the auditor would normally evaluate a vendor's compliance by reviewing the auditee's records and the results of the auditee's procedures for ensuring compliance by the vendor. When the auditor cannot obtain sufficient assurance of compliance from reviewing the auditee's records and procedures, a control deficiency exists. The auditor must evaluate the deficiency and consider whether it is a significant deficiency or material weakness. The auditor also should perform additional procedures to determine compliance. These procedures may include testing the vendor's records or obtaining reports on compliance procedures performed by the vendor's independent auditor.

11.17 Prior to performing a single or program-specific audit, it is important for the auditor to understand the nature of the auditee's vendor relationships, whether the vendors are responsible for program compliance, the auditee's procedures for ensuring vendor compliance, and whether it will be necessary for the auditor to test vendor records. The auditor should consider including such information in the communication used to establish an understanding with the auditee, since the amount and type of work done by the auditor may be impacted by the nature of the auditee's relationships with its vendors. (Chapter 6, "Planning Considerations of Circular A-133," of this guide discusses establishing an understanding with the auditee.) If subsequent to undertaking a single or program-specific audit the auditor becomes aware of a significant vendor relationship that will require the auditor to perform additional procedures on vendor records, the auditor should inform the auditee that the requirements of Circular A-133 will not be met unless additional procedures are performed. If

the auditee or vendor precludes the auditor from performing such additional procedures, the auditor should qualify his or her opinion or disclaim an opinion because of a scope limitation. (Chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide further discusses scope limitations.)

Single Audit Considerations of Pass-Through Entities

11.18 The following matters are relevant to planning and conducting a single audit of a pass-through entity, and discussed in the rest of this section of this chapter:

- Pass-through entity responsibilities
- Audit planning considerations
- Consideration of internal control over compliance
- Subrecipient monitoring
- Reporting considerations
- For-profit subrecipients
- Non-U.S.-based entities
- A state's designation of a cluster of programs

Pass-Through Entity Responsibilities

11.19 A pass-through entity is responsible for ensuring that subrecipients expend awards in accordance with applicable laws, regulations, and provisions of contracts or grants. Circular A-133 states that a pass-through entity should perform the following for the federal awards it provides to subrecipients:

- Identify the federal awards made by informing each subrecipient of the *Catalog of Federal Domestic Assistance* title and number, the award's name and number, the award year, whether the award is for research and development, and the name of the federal agency. When some of this information is not available, the pass-through entity should provide the best information available to describe the federal award.
- Advise subrecipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements, as well as any supplemental requirements imposed by the pass-through entity.
- Monitor the activities of subrecipients as necessary to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- Ensure that subrecipients expending \$500,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of Circular A-133 for that fiscal year.
- Issue management decisions on audit findings within six months after receipt of subrecipients' audit reports, and ensure that subrecipients take appropriate and timely corrective action.
- Consider whether subrecipient audits necessitate the adjustment of the pass-through entity's own records.

- Require subrecipients to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with Circular A-133.
- Keep subrecipients' report submissions (or other written notification when the subrecipient is not required to submit a reporting package) on file for three years from the date of receipt. (See the further discussion in paragraph 11.47.)

Audit Planning Considerations

Effect of Pass-Through Federal Awards on the Determination of Major Programs

11.20 As noted in paragraph 11.04, the determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards provided by a pass-through entity to subrecipients, the federal awards are deemed to be expended by the pass-through entity when the funds are disbursed to subrecipients, regardless of when subrecipients expend the federal funds. Accordingly, the amount of federal funds disbursed to subrecipients should be included in the total expenditures of federal awards of the pass-through entity and in the determination of the pass-through entity's major programs. (Chapter 8, "Determination of Major Programs," of this guide discusses the determination of major programs.)

Pass-Through Entity Request for a Program to Be Audited as a Major Program

11.21 When a subrecipient expends \$500,000 or more of federal awards, Circular A-133 permits the pass-through entity to request that the program be audited as a major program in lieu of the pass-through entity conducting or arranging for additional audits. If the pass-through entity makes such a request, it should pay the full incremental cost for such an audit. (Chapters 5, "Overview of the Single Audit Act, Circular A-133, and the *Compliance Supplement*," and 8 of this guide provide additional information.)

Materiality

11.22 The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely upon the auditor's work. A comparison of the amount of federal funds passed through to subrecipients with the total amount of expenditures for each individual major program or cluster can assist the auditor in determining if the pass-through amount is material. When the amount of federal funds passed through to subrecipients is material either quantitatively or qualitatively, in relation to the major program being audited, the need is greater for the auditor to test the subrecipient monitoring requirements. Some federal programs are designed in such a manner that subrecipient expenditures are intended to be material to the pass-through entity's award. For example, the Community Services Block Grant requires a state to subgrant at least 90 percent of the state's award.

Consideration of Internal Control Over Compliance

11.23 As part of performing procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan

the audit of the pass-through entity to support a low assessed level of control risk for major programs, the auditor should consider the pass-through entity's internal control over compliance used to monitor subrecipients. (See chapter 9, "Consideration of Internal Control Over Compliance for Major Programs," of this guide.) Tests of internal control over compliance used to monitor subrecipients may include inquiry, observation and inspection of documentation, or a reperformance by the auditor of some or all of the monitoring procedures identified in paragraph 11.28. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the internal control over compliance, materiality, and professional judgment. Part 6 of the *Compliance Supplement*, which is available to assist the auditor in evaluating internal control over compliance, describes (among other things) certain characteristics of internal control over compliance that, when present and operating effectively, may ensure compliance with program requirements for subrecipient monitoring. The results of the auditor's testing of internal control over compliance assist in determining the nature, timing, and extent of subrecipient monitoring compliance testing.

Subrecipient Monitoring

11.24 The Single Audit Act Amendments of 1996 (the Single Audit Act) requires the pass-through entity to monitor subrecipients' use of federal awards through site visits, limited scope audits, or other means. Because the pass-through entity is held accountable for federal awards administered by its subrecipients, the pass-through entity needs to establish an appropriate subrecipient monitoring process and to decide what, if any, additional monitoring procedures may be necessary to ensure the subrecipients' compliance. Generally, arrangements for subrecipient monitoring and clarification of the applicable compliance requirements relating to federal awards passed through are made by the pass-through entity in its agreements with subrecipients.

11.25 Auditors should consider subrecipient monitoring in a compliance audit of an entity that disburses to subrecipients federal awards that are material to a major program. (Paragraph 11.22 discusses materiality.) The auditor should consider whether the pass-through entity monitors subrecipients and has established internal control over compliance that provides reasonable assurance that subrecipients are managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of the pass-through entity's major programs.

Compliance Supplement Guidance

11.26 One of the 14 types of compliance requirements included in the *Compliance Supplement* is subrecipient monitoring. The *Compliance Supplement* identifies several audit objectives for subrecipient monitoring. According to the *Compliance Supplement*, in a single audit of a pass-through entity, the auditor should obtain an understanding of internal control, assess risk, and test internal control as required by the circular, and determine whether the pass-through entity:

- Properly identified federal award information and compliance requirements to the subrecipient, and approved only allowable activities in the award documents.

- Monitored subrecipient activities to provide reasonable assurance that the subrecipient administers federal awards in compliance with federal requirements.
- Ensured that the required audits were performed, issued a management decision on audit findings within six months after receipt of the subrecipient's audit report, and ensured that the subrecipient took timely and appropriate corrective action on all audit findings.
- Took appropriate action using sanctions in cases of continued inability or unwillingness of a subrecipient to have the required audits.
- Evaluated the effect of subrecipient activities on the pass-through entity.

11.27 As discussed in chapter 10 of this guide, the *Compliance Supplement* also identifies the suggested audit procedures for testing the compliance audit objectives for pass-through entities. The auditor may consider coordinating the subrecipient-related tests performed as part of cash management (tests of cash reports submitted by subrecipients), eligibility (tests that subawards were made only to eligible subrecipients), and procurement (tests of suspension and debarment certifications) with the tests of subrecipient monitoring.

Pass-Through Entity Monitoring Procedures

11.28 Part 3 of the *Compliance Supplement* discusses the pass-through entity's subrecipient monitoring responsibilities and activities. The monitoring procedures that a pass-through entity may use include on-site visits, reviews of financial and performance reports submitted by the subrecipient, regular contacts with subrecipients and appropriate inquiries concerning program activities, and limited-scope audits. Limited-scope audits are agreed-upon procedures engagements that are conducted in accordance with the AICPA attestation standards, and that are paid for and arranged by a pass-through entity and only address one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs or cost principles; eligibility; matching, level of effort, and earmarking; and reporting. Following are other monitoring procedures that a pass-through entity may perform:

- Reviewing grant applications submitted by subrecipients to determine that
 - applications are filed and approved in a timely manner.
 - each application contains the condition that the subrecipient comply with the federal requirements set by the federal agency.
- Establishing that internal control over compliance provides reasonable assurance that
 - funds are disbursed to subrecipients only on an as-needed basis.
 - funds are disbursed to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis.

- refunds that are due from subrecipients are billed and collected in a timely manner.
- subrecipients and other entities and individuals receiving federal funds meet eligibility requirements.
- Reviewing financial and technical reports received from subrecipients on a timely basis and investigating unusual items
- Reviewing subrecipient audit reports to evaluate them for completeness and for compliance with applicable laws and regulations
- Evaluating audit findings; issuing appropriate management decisions, if necessary; and determining if an acceptable plan for corrective action has been prepared and implemented
- Reviewing previously detected deficiencies and determining that corrective action was taken

Monitoring When the Subrecipient Has a Single or Program-Specific Audit

11.29 As noted in paragraph 11.03, subrecipients that expend \$500,000 or more in federal awards should have a single or program-specific audit in accordance with Circular A-133. If subrecipients have a single or program-specific audit, the pass-through entity's receipt and review of the results of that audit and its action on related findings may be sufficient to meet the subrecipient monitoring requirements of Circular A-133.² However, it is more likely that the receipt and review of such audit results is only one tool used by the pass-through entity as part of a comprehensive subrecipient-monitoring process. This is because a single audit is likely to provide varying degrees of assurance concerning a particular program. For example, a pass-through award may not have been tested as a major program as part of a subrecipient's audit. For this reason, the pass-through entity should consider the testing and results of the single audit of the subrecipient to determine what effect those results should have on other monitoring procedures employed by the pass-through entity.

11.30 In many cases, the pass-through entity will not have received all the subrecipient audit reports covering the time period being audited at the pass-through entity in time to incorporate the results into its own audit. The reports for the pass-through entity and the subrecipient are not required to be issued simultaneously, but the pass-through entity should have internal control over compliance in place to determine that (a) subrecipient audit reports have been received and (b) corrective action is taken after the receipt of the subrecipient's audit. If the subrecipient's audit report is current, it need not cover the same period as the pass-through entity's audit. If the pass-through entity has an effective system for monitoring subrecipients, its auditor would be more likely to rely on the subrecipient's audit cycle, even if it is not coterminous with the pass-through recipient's fiscal year.

² As discussed in paragraph 11.47, a subrecipient is not required to submit its audit report to the pass-through entity when it has no audit findings or the summary schedule of prior audit findings does not report the status of any audit findings. The *OMB Circular A-133 Compliance Supplement (Compliance Supplement)* suggests that in those situations a pass-through entity may use the information in the Federal Audit Clearinghouse (FAC) database (available at the FAC Web site at <http://harvester.census.gov/sac>) as evidence to verify that the subrecipient had "no audit findings" and that the required audit was performed.

Considering Risk Factors When Developing Monitoring Procedures

11.31 The *Compliance Supplement* states that the OMB expects pass-through entities to consider various risk factors (such as the relative size and complexity of the federal awards administered by subrecipients and other subrecipient risks including the entity's prior experience with each subrecipient) in developing the nature, timing, and extent of subrecipient monitoring procedures. Consider, for example, a pass-through entity that provides a large percentage of the only federal award it expends to 10 subrecipients that each expends less than \$500,000 in federal awards annually. Careful consideration by the pass-through entity of the most effective method of monitoring these federal awards is needed. Perhaps the majority of this federal award is provided to 2 of the subrecipients. If so, the pass-through entity might consider conducting site visits at the 2 subrecipients that received the majority of the federal award and simply reviewing the documentation supporting requests for reimbursement from the other 8 subrecipients. Conversely, if a small percentage of a federal award is provided to subrecipients that each expends less than \$500,000 in federal awards, the risk to the pass-through entity is most likely low and, therefore, the monitoring procedures could be minimal.

Unallowable Audit Costs

11.32 For subrecipients that expend less than \$500,000 in federal awards annually, the cost of any audits or attestation engagements (other than the limited-scope audits paid for and arranged by a pass-through entity as described in paragraph 11.28), are not allowable costs and, therefore, cannot be charged to any federal award. Accordingly, Circular A-133 would prohibit the cost of a financial statement audit conducted in accordance with GAAS or *Government Auditing Standards* from being charged (by either a pass-through entity or subrecipient) to federal awards for a subrecipient that expends less than \$500,000 in federal awards annually. Chapter 5 of this guide discusses the allowability of audit costs in greater detail.

When the Subrecipient Monitoring System Is Not Sufficient

11.33 The auditor may determine that the pass-through entity's subrecipient-monitoring system is not sufficient to ensure the subrecipient's compliance with laws, regulations, and the provisions of grants and contracts. In this situation, the auditor should report a significant deficiency (and possibly a material weakness) and consider whether the insufficient monitoring system represents an instance of noncompliance that should be reported as a compliance finding. The effect of the noncompliance on the opinion on compliance for major programs is primarily a function of the pervasiveness of the lack of monitoring and the materiality of subrecipient funding to a program. For example, if the pass-through entity did not perform subrecipient-monitoring procedures and 90 percent of the program was passed through to subrecipients, an opinion modification would likely be warranted. This would likely be the case even if the scope of the audit was expanded to include additional audit procedures to determine that the subrecipients actually complied with laws and regulations.

11.34 There may be instances in which the pass-through entity asks the auditor to perform additional procedures to determine the compliance of a subrecipient (such as conducting tests of records at the subrecipient's site). This would be considered an expansion of the scope of the audit. This expansion of the scope of the audit would not be sufficient to remedy the significant deficiency

(or material weakness) and, if applicable, noncompliance of the pass-through entity's monitoring system. However, an expansion of the scope of the audit may remedy the noncompliance related to the type of compliance requirement being tested (for example, eligibility).

11.35 The auditor also should consider any implications of an insufficient subrecipient-monitoring system on the opinion on the financial statements. If amounts passed through to subrecipients are considered material to the financial statements of the pass-through entity, the auditor should determine whether the report on the financial statements should be modified. Before making this determination, the auditor should take into consideration any audit evidence that may be available to the auditor (such as subrecipients' Circular A-133 audit reports and other financial reports that may have been submitted to the pass-through entity) that could indicate that the subrecipients administered the program in compliance with laws and regulations. Further, the auditor also should consider whether it is necessary to report an internal control or compliance finding in the report issued to meet the requirements of *Government Auditing Standards*.

Reporting Considerations

Schedule of Expenditures of Federal Awards

11.36 Circular A-133 states that, to the extent practical, pass-through entities should identify in the schedule of expenditures of federal awards the total amount provided to subrecipients from each federal program. (Chapter 7, "Schedule of Expenditures of Federal Awards," of this guide discusses the schedule.) If a pass-through entity is unable to identify amounts provided to subrecipients, the auditor should consider whether a significant deficiency (and possibly a material weakness) should be reported. The auditor also should consider whether material noncompliance (for subrecipient monitoring) has occurred, which should be reported as an audit finding.

Evaluation of Audit Findings

11.37 Circular A-133 requires the auditor to consider a finding in relation to the type of compliance requirement (subrecipient monitoring, in this case) or an audit objective identified in the *Compliance Supplement*, whether or not the finding can be quantified. For example, the auditor may discover that a pass-through entity consistently failed to provide its subrecipients with federal award information, including applicable compliance requirements. The pertinent audit objective included in the *Compliance Supplement* and relating to this example is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient." Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance is material in relation to the audit objective and, therefore, should be reported as an audit finding. In addition, the auditor should consider whether significant deficiencies (and possibly, material weaknesses in internal control) exist and require reporting with respect to subrecipient monitoring.³

³ Chapters 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," and 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide discuss the *Government Auditing Standards* requirement that the auditor communicate certain matters to the auditee in a written communication (commonly a management letter).

Effect of Subrecipients' Noncompliance on the Pass-Through Entity's Report

11.38 The instances of noncompliance reported in subrecipients' audit reports are not required to be included in the pass-through entity's audit report. However, the auditor of the pass-through entity should consider the effects of reported instances of subrecipient noncompliance or indications of weaknesses in the pass-through entity's subrecipient-monitoring system that could have a material effect on each of the pass-through entity's major programs.

Adjustment of Pass-Through Entity Financial Records and Reports

11.39 Questioned costs at the subrecipient level that are found to be unallowable by the pass-through entity may require the pass-through entity to adjust its financial records and its federal expenditure reports. The total of allowable program costs in excess of required expenditure levels and the requirements of individual programs regarding the timing of claims will affect whether the pass-through entity will need to reflect a liability to the awarding agency in its financial statements. As part of the finding-resolution process, the pass-through entity should estimate the total unallowable costs that are associated with each subrecipient finding and consider the need to adjust financial records and federal expenditure reports. The failure of the pass-through entity to adjust its records and federal reports should be considered by the auditor in forming an opinion on compliance for major programs.

For-Profit Subrecipients

11.40 Because Circular A-133 does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. Circular A-133 states that the contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for federal awards made to for-profit subrecipients may include preaward audits, monitoring during the contract, and postaward audits. The auditor's responsibilities related to for-profit subrecipients are similar to those of not-for-profit subrecipients; see paragraphs 11.24–.35 (as applicable) for a further discussion of subrecipient monitoring.

Non-U.S.-Based Entities

11.41 As discussed in chapter 5 of this guide, Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient. Therefore, the responsibilities that a pass-through entity and its auditor have for a non-U.S.-based entity are the same as those for a for-profit subrecipient (see paragraph 11.40).

State Designation of a Cluster of Programs

11.42 Circular A-133 includes a provision that allows a state to designate as a cluster a grouping of closely related programs that share common compliance requirements. When designating a cluster of programs, a state should identify the federal awards included in the cluster and to advise subrecipients of the compliance requirements applicable to the cluster. (Chapter 5 of this guide discusses clusters of programs.)

Circular A-133 Audit Considerations of Subrecipients

11.43 Subrecipients may have additional audit considerations under Circular A-133 that their auditors may need to address. These considerations, as discussed in this section, concern (a) additional compliance requirements that may be established by the pass-through entity, (b) information included in the schedule of expenditures of federal awards, (c) audit findings, and (d) the submission of the report.

Additional Compliance Requirements Established by Pass-Through Entities

11.44 Federal awards normally are distributed to subrecipients only on the basis of properly completed and approved awards. These written agreements require subrecipients to comply with the requirements of the federal agency and, in some instances, additional requirements established by the pass-through entity. Hence, in addition to providing an audit satisfying the requirements of Circular A-133, the auditor may be engaged to test compliance with requirements specified by the pass-through entity.

Information Included in the Schedule of Expenditures of Federal Awards

11.45 For federal awards received as a subrecipient, Circular A-133 states that the schedule of expenditures of federal awards should include the name of the pass-through entity and identifying number assigned by the pass-through entity. Circular A-133 states that, to make the schedule easier to use, subrecipients may choose to provide information requested by federal awarding agencies and pass-through entities, although this information is not required. Chapter 7 of this guide discusses the schedule.

Audit Findings

11.46 Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as one audit finding. Circular A-133 states that where practical, audit findings should be organized by federal agency or pass-through entity. (Chapter 12 of this guide discusses audit findings).

Submission of Report

11.47 Section 320(e) of Circular A-133 has additional report-submission responsibilities for subrecipients. When a subrecipient is not required to submit a reporting package to the pass-through entity (because for the pass-through entity's programs the subrecipient has no audit findings and the summary schedule of prior audit findings does not report the status of any audit findings), the subrecipient should provide written notification of this to the pass-through entity. Chapter 12 of this guide discusses the required contents of the written notification and the submission of the report by subrecipients.

Chapter 12

Auditor Reporting Requirements and Other Communication Considerations in a Single Audit

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (Chapters 2–4 of this guide), discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in part I of this guide in addition to the guidance in part II, "Circular A-133 Audits" (Chapters 5–13 of this guide).

Overview

12.01 This chapter discusses the auditor's reporting requirements and other communication considerations in a single audit under OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. It also provides illustrative auditor's reports in appendix A (paragraph 12.54). (Chapter 13, "Program-Specific Audits," discusses the auditor's reporting requirements in and provides illustrative reports for a program-specific audit.)

12.02 The auditor's reporting responsibilities in a single audit are driven by the three levels of auditing standards and requirements: generally accepted auditing standards (GAAS), *Government Auditing Standards*, and Circular A-133. These standards and requirements expand the level of auditor responsibility from reporting on an auditee's financial statements to also reporting on internal control and on compliance. The auditor has additional reporting responsibilities for the audit of the financial statements in accordance with *Government Auditing Standards* (see chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide), and for the compliance audit applicable to major programs in accordance with Circular A-133 (see chapters 8–10 of this guide). The auditor also has certain additional communication considerations under GAAS and *Government Auditing Standards* related to internal control, fraud, illegal acts, violations of contracts or grant agreements, abuse, and other matters identified in the audit as discussed in this chapter and in chapter 4 of this guide.

Circular A-133 Requirements

Auditor's Reports

12.03 Circular A-133 states that the auditor's report(s) should include the following:

- An opinion (or disclaimer of opinion)¹ on whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) (paragraph 12.10 discusses basis of accounting) and an opinion (or a disclaimer of opinion) on whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- A report on the internal control related to the financial statements and on the internal control related to major programs. This report should describe the scope of testing of internal control and the results of the tests and, where applicable, refer to the separate schedule of findings and questioned costs.
- A report on compliance with laws, regulations, and the provisions of contracts or grant agreements (hereinafter referred to as *compliance requirements*), noncompliance with which could have a material effect on the financial statements. This report also should include an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program, and where applicable, refer to the separate schedule of findings and questioned costs.
- A schedule of findings and questioned costs.

Paragraphs 12.07–.09 describe the auditor's reports recommended in this guide.

Data Collection Form

12.04 Circular A-133 also states that the auditor should complete applicable sections of and sign a data collection form that summarizes the auditor's results, findings, and questioned costs. (See paragraphs 12.44–.52.)

Reporting Package

12.05 The auditee should submit a reporting package that includes the following:

- Financial statements and a supplementary schedule of expenditures of federal awards (see chapter 7, "Schedule of Expenditures of Federal Awards," of this guide)
- Auditor's reports (see paragraphs 12.07–.09)
- A summary schedule of prior audit findings (see paragraphs 12.41–.42)
- A corrective action plan (see paragraphs 12.41–.43)

12.06 Although not part of the reporting package, the report submission to the Federal Audit Clearinghouse (FAC) also should include the data collection form described in paragraphs 12.44–.46, part of which the auditee completes.

¹ As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government's basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. In addition, the auditor may provide opinions or disclaimers of opinions on additional opinion units if engaged to set the scope of the audit and assess materiality at a more detailed level than by the opinion units required for the basic financial statements. Throughout this guide, the use of the singular terms *opinion* and *disclaimer of opinion* encompasses the multiple opinions and disclaimers of opinion that generally will be provided on a government's financial statements.

Paragraphs 12.47–52 discuss the reporting package and data collection form submission requirements.

Recommended Auditor's Reports

12.07 Reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this guide recommends that the following reports be issued:

- a. A report on the financial statements and on the supplementary schedule of expenditures of federal awards² (see paragraphs 12.10–.15)
- b. A report on internal control over financial reporting³ and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards* (see paragraphs 12.16–.17)
- c. A report on compliance with requirements applicable to each major program and on internal control over compliance⁴ in accordance with Circular A-133 (see paragraphs 12.18–.24)
- d. A schedule of findings and questioned costs (see paragraphs 12.31–.40)

12.08 Appendix A (paragraph 4.51) in chapter 4 of this guide and appendix A (paragraph 12.54) in this chapter present illustrative auditor's reports for single audits. As noted previously, those reports combine reports on compliance and internal control at the financial statement audit level and at the major program compliance audit level. Because the reports in appendix A are illustrative, auditors may tailor the reporting based on the auditor's understanding of the intended purpose of the reports and the specific auditee facts and circumstances. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, it is necessary to exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. The basic elements of each of the recommended reports are discussed later in this chapter. Professional judgment may be exercised in any situation not specifically addressed in this guide.

12.09 Table 12-1 provides a matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133.

² Note that in certain circumstances the auditor may report on the schedule of expenditures of federal awards in his or her report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. See paragraph 12.15 for a further discussion.

³ Controls relevant to an audit of the financial statements are referred to collectively in this guide as "internal control over financial reporting" and are encompassed in the reporting on internal control required by *Government Auditing Standards*.

⁴ Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this guide as "internal control over compliance" and are encompassed in the reporting on internal control required by Circular A-133.

Table 12-1

Recommended Reporting in Single Audits

| Report | GAAS | Required by | |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|-------------------------------|----------------|
| | | Government Auditing Standards | Circular A-133 |
| Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards | X | X | X |
| Report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements | | X | X |
| Report on compliance and internal control over compliance applicable to <i>each</i> major program (this report includes separate opinions [or disclaimers of opinion] on each major program's compliance) | | | X |
| Schedule of findings and questioned costs | | | X |

Reporting on the Financial Statements and Supplementary Schedule of Expenditures of Federal Awards in Accordance With GAAS and Government Auditing Standards

Basis of Accounting

12.10 Circular A-133 does not prescribe the basis of accounting that auditees use to prepare their financial statements or the schedule of expenditures of federal awards. However, auditees should disclose the bases of accounting and the significant accounting policies used in preparing the financial statements and the schedule of expenditures of federal awards. Further, as noted in chapter 7 of this guide, a reconciliation of the amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards will assist the auditee in providing evidence to the auditor regarding the accuracy of the amounts presented. Circular A-133 states that the auditor should issue an opinion (or a disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with GAAP⁵ and as to whether the schedule of expenditures of federal awards is presented fairly

⁵ AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), defines the comprehensive bases of accounting other than generally accepted accounting principles, known as

(continued)

in all material respects in relation to the auditee's financial statements taken as a whole.

Implementing Regulations of Federal Awarding Agencies May Define the Entity to Be Audited Differently Than Does GAAP

12.11 The regulations implementing Circular A-133 may define the entity to be audited for single audit purposes differently than the reporting entity would be defined in conformity with GAAP. For example, Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), requires presentation of consolidated financial statements when one not-for-profit organization (NPO) (the parent) controls the voting majority of the board of and has an economic interest in another NPO. If the regulations of the federal agency that provides federal awards to the parent define the entity for single audit purposes to consist of only the parent, audited parent-only financial statements instead of consolidated financial statements should be submitted to comply with these regulations. If the NPO's consolidated financial statements are not also prepared as required by GAAP, the auditor should consider whether to express an other than unqualified opinion due to a material departure from GAAP on the parent-only financial statements. Paragraphs .35–.60 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), and various AICPA Audit and Accounting Guides, including *Health Care Organizations*, *Not-for-Profit Organizations*, and *State and Local Governments*, provide guidance on reporting when there is a departure from GAAP.

Report on the Financial Statements and on the Supplementary Schedule of Expenditures of Federal Awards

12.12 Chapter 4 of this guide describes the requirements of the auditor's standard report on the financial statements and on accompanying supplementary information—required supplementary information (RSI) and supplementary information other than RSI (known as SI). Appendix A (paragraph 4.51) in chapter 4 of this guide illustrates that report. With regard to the schedule of expenditures of federal awards, this guide recommends that the auditor report on that schedule in the report on the financial statements as SI; see illustrative paragraphs for that report in paragraphs 12.13–.14.⁶ (See paragraph 12.15 if

(footnote continued)

other comprehensive bases of accounting (OCBOA), and establishes requirements for reporting on audits of OCBOA financial statements. Auditing Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)," and No. 15, "Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request," of AU section 623 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .90–.98), provide additional guidance on reporting on audits of OCBOA financial statements. The AICPA Audit and Accounting Guide *State and Local Governments* discusses the application of AU section 623 and those interpretations to state and local governmental financial statements. That guide and paragraph .97 of Interpretation No. 15 also provide illustrative auditor's reports on OCBOA financial statements. In addition, in the AICPA's Practice Aid Series, two publications—*Applying OCBOA in State and Local Governmental Financial Statements* and *Preparing and Reporting on Cash- and Tax-Basis Financial Statements*—provide nonauthoritative guidance on preparing and reporting on OCBOA financial statements.

⁶ AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), and paragraph .07 of AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), provide guidance on such reporting.

the schedule does not accompany the financial statements.) Accordingly, the report on the financial statements as it relates to the schedule of expenditures of federal awards should include the following:

- a. An identification of the schedule of expenditures of federal awards as accompanying supplementary information. This identification may be by descriptive title or by page number of the document.
- b. A statement that the audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole (or for the purpose of forming opinions on the financial statements that collectively comprise the basic financial statements of a state or local government), and that the schedule of expenditures of federal awards required by Circular A-133 is presented for purposes of additional analysis and is not a required part of the financial statements.
- c. An opinion on whether the schedule of expenditures of federal awards is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

12.13 The following is an illustrative paragraph for the auditor's reporting on the schedule of expenditures of federal awards for a state or local government:

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the City of Example's basic financial statements. The accompanying schedule of expenditures of federal awards⁷ is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.⁸

12.14 The following is an illustrative paragraph for the auditor's reporting on the schedule of expenditures of federal awards for an NPO:

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying schedule of expenditures of federal awards⁹ is presented for purposes of additional analysis as required by U.S. Office of Management and

⁷ If the auditor is reporting on additional supplementary information (for example, combining and individual nonmajor fund financial statements and schedules), this paragraph should be modified to describe the additional supplementary information. See the illustrative report in appendix A (paragraph 4.51) in chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide as well as the illustrative reports in the AICPA Audit and Accounting Guide *State and Local Governments* and AU section 550.

⁸ When reporting on the supplementary information, the auditor should consider the effect of any modifications to the report on the basic financial statements. (See also paragraph 12.29.) Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs .09–.11 and .13–.14 of AU section 551.

⁹ If the auditor is reporting on additional supplementary information (for example, a comparison of actual and budgeted expenses), this paragraph should be modified to describe the additional supplementary information. AU section 551 provides useful guidance.

Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.¹⁰

12.15 Some entities do not present the schedule of expenditures of federal awards with the financial statements; that is, they issue a separate single audit package. In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. Footnotes in the illustrative reports in appendix A (paragraph 12.54), examples 12-1–12-5, illustrate how to incorporate the reporting on the schedule into the Circular A-133 report. See also paragraphs 12.26–.28 for information on dating the reports in that situation.

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

12.16 As discussed in chapter 4 of this guide, *Government Auditing Standards* states that the auditor should issue a report that describes the scope of the auditor's testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements and present the results of those tests. *Government Auditing Standards* also states that the auditor should report, as applicable to the objectives of the audit, (a) significant deficiencies in internal control over financial reporting, (b) instances of fraud and illegal acts¹¹ unless inconsequential,¹² (c) material violations of provisions of contracts or grant agreements, and (d) material abuse. (Chapter 4 of this guide describes the requirements of the auditor's standard report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*. Appendix A (paragraph 4.51) in that chapter illustrates that report.) In an audit conducted in accordance with Circular A-133, the auditor should apply a financial statement materiality consideration in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting. That is because those

¹⁰ See footnote 8.

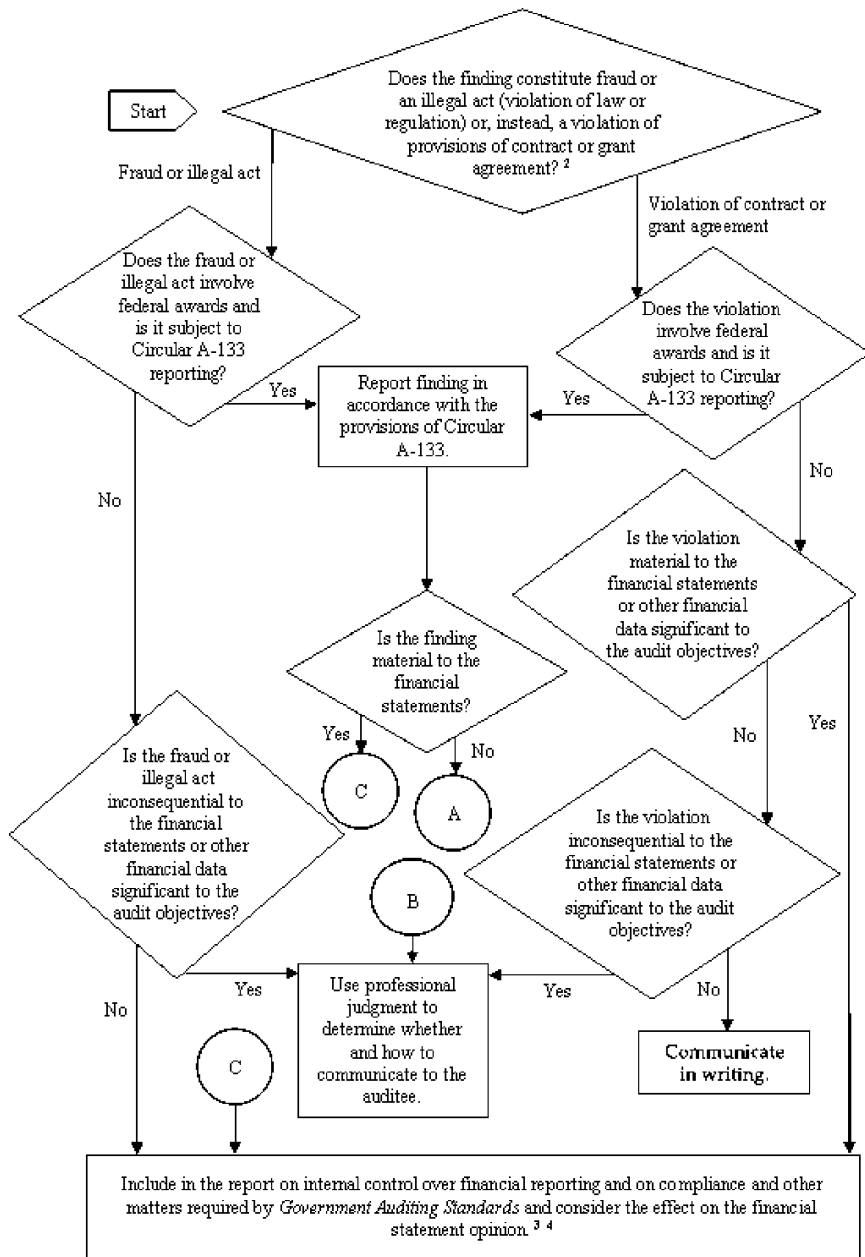
¹¹ Paragraph 4.28 of *Government Auditing Standards* and paragraph .02 of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), define the term *illegal acts* as violations of laws and regulations. As indicated in chapter 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide, it generally has been interpreted under generally accepted auditing standards that the term *laws and regulations* in AU section 317 implicitly includes provisions of contracts or grant agreements. This guide sometimes collectively refers to laws, regulations, and provisions of contracts and grant agreements as *compliance requirements* and to illegal acts and violations of provisions of contracts or grant agreements as *noncompliance* or *instances of noncompliance*.

¹² Footnote 64 to paragraph 5.10 of *Government Auditing Standards* states that if the auditor is performing an audit in accordance with Circular A-133, the circular defines the thresholds for reporting and that those thresholds are sufficient to meet the requirements of *Government Auditing Standards*. Paragraph 12.35 lists the fraud and illegal acts related to federal awards that Circular A-133 requires to be reported.

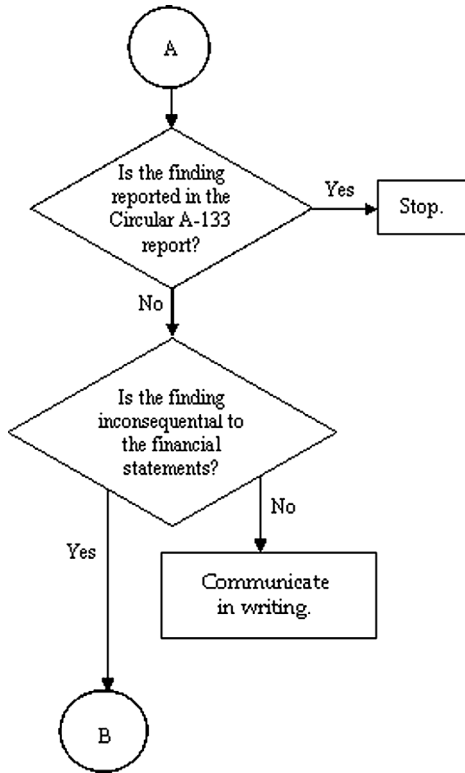
findings already are reported in the Circular A-133 report and reporting findings that are not material to the financial statements again in the *Government Auditing Standards* report would be unnecessarily duplicative. (See paragraph 12.35.) Exhibit 12-1 is a flowchart that illustrates the evaluation and reporting of findings of fraud and noncompliance under *Government Auditing Standards* when the auditee is subject to an audit in accordance with Circular A-133 audit. (Chapter 4 of this guide presents a flowchart that illustrates the evaluation and reporting of findings of fraud and noncompliance under *Government Auditing Standards* when the auditee is not subject to an audit in accordance with Circular A-133.) Chapter 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," of this guide includes a flowchart that illustrates its discussion of the evaluation and reporting of findings of abuse.

Exhibit 12-1

Evaluation and Reporting of Findings of Fraud and Noncompliance Under *Government Auditing Standards* and Circular A-133¹



(continued on next page)



¹ This flowchart represents the evaluation and reporting of findings of fraud and noncompliance (illegal acts and violations of provisions of contracts or grant agreements) under *Government Auditing Standards* when the auditee is subject to an audit in accordance with Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. In a Circular A-133 audit, the auditor should apply a financial statement materiality consideration in reporting fraud and illegal acts (those that concern the left leg of this flowchart) in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting. That is because those findings already are reported in the Circular A-133 report and reporting findings that are not material to the financial statements again in the *Government Auditing Standards* report would be unnecessarily duplicative. Chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide presents a flowchart that illustrates the evaluation and reporting of findings of fraud and noncompliance when the auditee is subject to an audit in accordance with *Government Auditing Standards*, but not an audit in accordance with Circular A-133.

² The auditor should consider the direct reporting requirement of *Government Auditing Standards*. Chapter 4 of this guide discusses the requirements in paragraphs 5.18–.20 of *Government Auditing Standards* that auditors report fraud and noncompliance directly to parties outside of the auditee in certain circumstances.

- ³ Chapter 4 of this guide discusses (a) how to report noncompliance findings that relate to both internal control over financial reporting and to compliance and (b) when to report fraud findings in the internal control section of the report or instead in the section on compliance and other matters.
- ⁴ If the finding is reported in both (a) the report on internal control over financial reporting and on compliance and other matters required by *Government Auditing Standards* and (b) the report on compliance with requirements applicable to each major program and on internal control over compliance required by Circular A-133, see paragraph 12.32c.

12.17 Circular A-133 states that the schedule of findings and questioned costs should include all findings, including those required to be reported under *Government Auditing Standards*. Accordingly, the report on internal control over financial reporting and on compliance and other matters should refer to the schedule of findings and questioned costs, which should describe the findings required to be reported under *Government Auditing Standards* as discussed in the previous paragraph. In addition, the separate paragraph at the end of the report stating that the report is intended solely for the information and use of certain parties also should refer to federal awarding agencies and, if applicable, pass-through entities.

Reporting on Compliance and Internal Control Over Compliance Applicable to Each Major Program

12.18 This section discusses the auditor's report and opinions that are issued based on a compliance audit of major programs in accordance with Circular A-133. The report on compliance with requirements applicable to major programs expresses the auditor's opinion on whether the auditee complied with the requirements that, if noncompliance occurred, could have a direct and material effect on a major program. Although the guidance in AU section 508 addresses reporting on audited financial statements, auditors may find its guidance useful when reporting on a compliance audit of major programs.

Material Instances of Noncompliance

12.19 When the audit of an auditee's compliance with requirements applicable to a major program detects material instances of noncompliance with those requirements, the auditor should express a qualified or adverse opinion on compliance in the report on compliance with requirements applicable to each major program and on internal control over compliance. The auditor should state the basis for such an opinion in the report as shown in appendix A (paragraph 12.54), examples 12-3, 12-4, and 12-5. The auditor also should consider the cumulative effect of all instances of noncompliance on the financial statements using the materiality level established for the basic financial statements.¹³ Chapter 10 of this guide discusses materiality considerations in evaluating the effect of instances of noncompliance on the opinion on compliance.

¹³ As discussed in the Audit and Accounting Guide *State and Local Governments*, the auditor's consideration of materiality for purposes of planning, performing, evaluating the results of, and reporting on the audit of the financial statements of a state or local government is based on opinion units.

Scope Limitations

12.20 Testing an auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements provides the evidence for the auditor to make a comply/noncomply decision about an auditee's adherence to those compliance requirements. The auditor is able to express an unqualified opinion only if he or she has been able to apply all the procedures the auditor considers necessary in the circumstances. Restrictions on the scope of the audit—whether imposed by the client or by circumstances such as the timing of the auditor's work, an inability to obtain sufficient appropriate audit evidence, or an inadequacy in the accounting records—may require the auditor to qualify his or her opinion or to disclaim an opinion. In those instances, the auditor's report should describe the reasons for such a qualification or disclaimer of opinion. Furthermore, the auditor should consider the effects of those instances on his or her ability to express an unqualified opinion on the financial statements. Appendix A (paragraph 12.54), example 12-4, illustrates a qualified opinion on compliance due to a scope limitation.

12.21 The auditor's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on compliance with requirements governing each major program. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to each major program. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance.

12.22 When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph all of the substantive reasons for the disclaimer. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should disclose any reservations he or she has regarding compliance with applicable laws and regulations.

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With Circular A-133

Report Requirements

12.23 The basic elements of the auditor's standard report on compliance with requirements applicable to each major program and on internal control over compliance¹⁴ in accordance with Circular A-133, as amended in a *Federal Register* Notice on June 26, 2007,^{*} are in the following listing. Appendix A (paragraph 12.54) examples 12-1–12-5 illustrate that report.

¹⁴ In a particular single audit engagement, some controls may involve both internal control over financial reporting and internal control over compliance and thus be relevant to both the audit of the financial statements and the audit of compliance. When this occurs, those controls would be encompassed in both internal control reports. Section 505 of Circular A-133 as amended by the Notice issued in the *Federal Register* on June 26, 2007, provides guidance on reporting findings involving significant deficiencies in internal control in such a circumstance as discussed in paragraph 12.32c.

^{*} The *Federal Register* Notice can be found on the OMB Web site at www.whitehouse.gov/omb/fedreg/2007/062607_audits.pdf.

- a. A statement that the auditor has audited the compliance of the auditee with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement (Compliance Supplement)* that are applicable to each of its major programs.
- b. A statement that the auditee's major programs are identified in the summary of the auditor's results section of the accompanying schedule of findings and questioned costs. (See paragraph 12.32a.)
- c. A statement that compliance with the requirements of laws, regulations, contracts, and grants applicable to each of the auditee's major federal programs is the responsibility of the auditee's management, and that the auditor's responsibility is to express an opinion on the auditee's compliance based on the audit.
- d. A statement that the audit of compliance was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards), the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States,¹⁵ and Circular A-133.
- e. A statement that those standards and Circular A-133 require that the auditor plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that could have a direct and material effect on a major federal program occurred.
- f. A statement that an audit includes examining, on a test basis, evidence about the auditee's compliance with those requirements and performing such other procedures as the auditor considered necessary in the circumstances.
- g. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.
- h. A statement that the audit does not provide a legal determination of the auditee's compliance with those requirements.
- i. If instances of noncompliance are noted that result in an opinion modification, a reference to a description in the accompanying schedule of findings and questioned costs, including:
 - The reference number(s) of the finding(s).
 - An identification of the type(s) of compliance requirements and related major program(s).
 - A statement that compliance with such requirements is necessary, in the auditor's opinion, for the auditee to comply with the requirements applicable to the program(s).
- j. An opinion on whether the auditee complied, in all material respects, with the types of compliance requirements that are applicable to each of its major federal programs.

¹⁵ The standards applicable to financial audits are the general, fieldwork, and reporting standards described in chapters 3–5 of *Government Auditing Standards*.

- k. If applicable, a statement that the results of the auditing procedures disclosed instances of noncompliance that are required to be reported in accordance with Circular A-133 and a reference to the schedule of findings and questioned costs in which they are described.¹⁶
- l. A statement that the auditee's management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs.
- m. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over compliance with requirements that could have a direct and material effect on a major federal program, to determine the auditing procedures for the purpose of expressing an opinion on compliance but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance.
- n. The definition of control deficiency and significant deficiency. If applicable, a statement that deficiencies were identified that are considered to be significant deficiencies in internal control over compliance.
- o. If applicable, a reference to a description of the significant deficiencies identified in the accompanying schedule of findings and questioned costs, including the reference number of the finding(s).
- p. If no significant deficiencies are identified, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in internal control that might be significant deficiencies or material weaknesses; if significant deficiencies are identified, a statement that the auditor's consideration of internal control over compliance would not necessarily disclose all matters in the internal control that might be significant deficiencies or material weaknesses and a statement that certain deficiencies were identified that are considered to be significant deficiencies (and, if applicable, material weaknesses).
- q. The definition of a material weakness.
- r. If applicable, a statement about whether the auditor believes any of the significant deficiencies identified are material weaknesses and, if they are, a reference to a description of the material weaknesses in the schedule of findings and questioned costs, including the reference number of the finding(s). (If there are no significant deficiencies identified, a statement is made that no material weaknesses were identified).
- s. If applicable, a statement that the auditee's response to the findings identified in the audit are described in the accompanying schedule of findings and questioned costs, and that the auditor did not audit the auditee's response and, accordingly, expresses no opinion on it.
- t. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of *[identify the body*

¹⁶ Paragraph 12.35 discusses the audit findings that are required to be reported under Circular A-133.

or individuals charged with governance], others within the entity, [identify the legislative or regulatory body], federal awarding agencies and (if applicable) pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.¹⁷

- u. The manual or printed signature of the auditor's firm.
- v. The date of the auditor's report.

Further, as discussed in paragraph 12.36, the auditor may need to modify the report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133 for abuse findings reported in the federal awards section of the schedule of findings and questioned costs.

Option to Report on the Schedule of Expenditures of Federal Awards

12.24 As discussed in paragraph 12.12, this guide recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, in certain circumstances (for example, when a separate single-audit package is issued), the auditor's report on the schedule may be incorporated into the report described in paragraph 12.23. A footnote in the illustrative report in appendix A (paragraph 12.54), example 12-1, illustrates how to incorporate the reporting on the schedule into the Circular A-133 report.

Communicating Other Findings to Management

12.25 The schedule of findings and questioned costs should include all audit findings required to be reported under Circular A-133. A separate communication (such as a management letter) may not be used to communicate such matters to the auditee in lieu of reporting them as audit findings in accordance with Circular A-133. As discussed in chapter 4 of this guide, paragraph 5.16 of *Government Auditing Standards* states that auditors should communicate in writing violations of provisions of contracts or grant agreements or abuse that have an effect on the financial statements that is less than material but more than inconsequential. This communication may be done in a management letter. Generally, *Government Auditing Standards* requires the auditor to evaluate findings for the purpose of communication in the management letter or other written communication based on their consequence to the financial statements or other financial data significant to the audit objectives. As shown in exhibit 3-1 in chapter 3 of this guide and in exhibit 12-1, in an audit in accordance with Circular A-133, however, the auditor should evaluate findings involving federal awards for the purpose of that communication based only on their consequence to the financial statements. Further, the auditor is not required to communicate such findings in a management letter or other written communication to entity officials if they are otherwise reported as audit findings in accordance with Circular A-133. The Circular A-133 report need not refer to the management letter or other written communication; as discussed in chapter 4 of this guide, that reference is made in the *Government Auditing Standards* report. In addition, as discussed in chapter 4 of this guide, *Government Auditing Standards* directs auditors to use professional judgment to determine whether and how to communicate to officials of the audited entity

¹⁷ This paragraph conforms to AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1). See AU section 532 for additional guidance on restricted-use reports.

fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse that are inconsequential and to document any such communications.

Other Reporting Considerations

Dating of Reports

12.26 Because the report on the schedule of expenditures of federal awards that is presented as supplementary information indicates that the auditor is reporting "in relation to" the basic financial statements, it should carry the same date as that on the report on the financial statements. Furthermore, because the report on internal control over financial reporting and on compliance and other matters, as required by *Government Auditing Standards*, relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it also should carry the same date.

12.27 The auditor's report on compliance and on internal control over compliance related to major programs, as required by Circular A-133, ordinarily carries the same date as that of the other reports, but may carry a later date, because some of the audit work to satisfy Circular A-133 requirements may be done subsequent to the work on the financial statements. When this is the case, the reporting required by Circular A-133 should be dated at the later date (that is, when the auditor has obtained sufficient appropriate audit evidence to support the report on the audit of compliance is completed). The auditor should perform subsequent events procedures from the date of the report on the financial statements to the date of the report on the compliance audit in accordance with AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1). AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance in situations where, after the date of the reports on the financial statements and on internal control over financial reporting and on compliance and other matters, the auditor becomes aware of misstatements, instances of noncompliance, or abuse that have a direct and material effect on financial statement amounts or other financial data significant to the audit objectives.

12.28 This guide recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, as noted in paragraphs 12.15 and 12.24, there may be circumstances in which the auditor reports on the schedule in the report on compliance and on internal control over compliance issued to meet Circular A-133 requirements. In that situation, the report issued to meet Circular A-133 requirements should be dated the same as the report on the financial statements. That is because the report on the schedule is "in relation to" the basic financial statements. If using the same date is not possible because the work to satisfy Circular A-133 requirements is not complete as of the date of the financial statement report, the auditor has two options:

- a. The auditor can dual date the report issued to meet Circular A-133 requirements. The date related to the portion of the report pertaining to the schedule of expenditures of federal awards would be the same as the date of the financial statement report. The date pertaining to the remainder of the report would be the date on which the work done to satisfy Circular A-133 requirements is completed. Refer to AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

- b. The auditor can issue a separate report on the schedule of expenditures of federal awards, dated the same date as that of the financial statement report.

In some instances, the auditor may be engaged to issue a stand-alone opinion on the schedule either as part of the report issued to meet the requirements of Circular A-133 or separately (dated the same as the Circular A-133 report). AU section 508 provides requirements and guidance when issuing such a report.

Other Auditors

12.29 When more than one independent auditor is involved in a single audit performed under Circular A-133, paragraphs .12–.13 of AU section 508 regarding an opinion on financial statements based in part on the report of another auditor, as well as AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1), (see chapter 4 for additional reporting considerations relating to other auditors) provides requirements and guidance. The principal auditor also may need to refer to the programs audited by other auditors in the auditor's reports on the schedule of expenditures of federal awards and on compliance with requirements applicable to each major program and on the internal control over compliance as they relate to federal awards administered by the component organization. In such cases, AU section 543 provides requirements and guidance. The AICPA Audit and Accounting Guide *State and Local Governments* also illustrates an auditor's report on the financial statements that refers to the work of another auditor in the paragraph reporting on SI, such as the schedule of expenditures of federal awards.

When the Audit of Federal Awards Does Not Encompass the Entirety of the Auditee's Operations

12.30 If the audit of federal awards does not encompass the entirety of the auditee's operations expending federal awards, the operations that are not included should be identified in a separate paragraph following the first paragraph of the report on major programs. (See also the discussion in chapter 6, "Planning Considerations of Circular A-133," of this guide concerning the definition of the entity to be audited.) An example of such a paragraph follows:

Example Entity's basic financial statements include the operations of the [identify component organization, such as a component unit or department], which received [include dollar amount] in federal awards which is not included in the schedule during the year ended June 30, 20X1. Our audit, described below, did not include the operations of [identify component organization] because [state the reason for the omission, such as the component unit engaged other auditors to perform an audit in accordance with OMB Circular A-133].

Schedule of Findings and Questioned Costs

12.31 Circular A-133 states that the auditor should prepare a schedule of findings and questioned costs, which should include the following three sections:

- a. A summary of the auditor's results
- b. Findings related to the financial statements that are required to be reported in accordance with *Government Auditing Standards*
- c. Findings and questioned costs for federal awards

Appendix A (paragraph 12.54) presents an illustrative schedule of findings and questioned costs in example 12-6.

What Should Be Reported

12.32 Specifically, Circular A-133, as amended in a *Federal Register* Notice on June 26, 2007, and Auditing Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit," of AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9325A par. .01-.04), requires the schedule of findings and questioned costs to contain the following:

- a. A summary of the auditor's results, which should include the following:
 - The type of report the auditor issued on the financial statements of the auditee (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).¹⁸
 - Where applicable, a statement that significant deficiencies in internal control were disclosed by the audit of the financial statements and whether any such deficiencies were material weaknesses.¹⁹
 - A statement on whether the audit disclosed any noncompliance that is material to the financial statements of the auditee.
 - Where applicable, a statement that significant deficiencies in the internal control over major programs were disclosed by the audit and whether any such deficiencies were material weaknesses.²⁰
 - The type of report the auditor issued on compliance for major programs (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - A statement on whether the audit disclosed any audit findings that the auditor is required to report under section 510(a) of Circular A-133 (see paragraph 12.35).²¹
 - An identification of major programs.
 - The dollar threshold used to distinguish between type A and type B programs as described in section 520(b) of Circular A-133 (see chapter 8 of this guide).
 - A statement on whether the auditee qualified as a low-risk auditee under section 530 of Circular A-133 (see chapter 8 of this guide).

¹⁸ As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government's basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. (See footnote 1.) Therefore, the schedule of findings and questioned costs may need to indicate multiple types of opinions on a government's basic financial statements.

¹⁹ AU section 325A, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), precludes an auditor from issuing a written report representing that no significant deficiencies were noted during an audit. Therefore, the illustrative schedule of findings and questioned costs in example 12-6 in appendix A (paragraph 12.54) uses the term *none reported* to indicate that no significant deficiencies were included in the auditor's report (versus *none*, which would imply that there were no significant deficiencies).

²⁰ See footnote 19.

²¹ As discussed in paragraph 12.36, the auditor may need to modify the summary of auditor's results for abuse findings reported in the federal awards section of the schedule of findings and questioned costs.

- b. Findings related to the financial statements that are required to be reported in accordance with *Government Auditing Standards* (see paragraph 12.35).
- c. Findings and questioned costs for federal awards, which should include audit findings as defined in section 510(a) of Circular A-133 (see paragraph 12.34) and which should include certain findings of abuse as required by *Government Auditing Standards* (see paragraph 12.36). Circular A-133 states that this section of the schedule should include the following:
 - Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as one finding. Where practical, audit findings should be organized by federal agency or pass-through entity.
 - Audit findings that relate to both the financial statements and the federal awards should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form, with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that affects the auditee as a whole, including its federal awards, usually should be reported in detail in the section of the schedule of findings and questioned costs that is related to the financial statements, with a summary identification and reference given in the section related to federal awards. Conversely, a finding of noncompliance with a federal program law that also is material to the financial statements should be reported in detail in the federal awards section of the schedule, with a summary identification and reference given in the financial statement section.

Findings Related to the Financial Statements²²

12.33 As noted before, Circular A-133 requires the schedule of findings and questioned costs to include a section that presents the detail of findings related to the financial statements. This section of the schedule should include all findings related to the audit of the financial statements that are required to be reported by GAAS and *Government Auditing Standards* in a Circular A-133 audit. (See paragraph 12.16.) Those findings are as follows:

- Significant deficiencies in internal control over financial reporting
- All instances of fraud and illegal acts unless inconsequential, except for fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting and that are not material to financial statement amounts
- Material violations of provisions of contracts and grant agreements
- Material abuse (see also paragraph 12.36)

²² There is no option for the auditor to report in a management letter, or other written communication, findings that *Government Auditing Standards* or Circular A-133 requires to be reported in the auditor's report or Schedule of Findings and Questioned Cost.

12.34 Chapter 4 of this guide discusses the details that *Government Auditing Standards* requires be reported for findings. That chapter also discusses the requirement in paragraph 5.26 of *Government Auditing Standards* that the auditor obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as their planned corrective actions. The auditor should present management views and planned corrective actions for findings related to the financial statement audit in the financial statement section of the schedule of findings and questioned costs. Alternatively, for audit findings that relate to both the financial statements and the federal awards and that are reported in both sections of the schedule of findings and questioned costs, depending on the status of the development of the corrective action plan at the time the auditor's reports are released, the auditor may be able to refer to the corrective action plan as the required presentation of the auditee's views and planned corrective actions.

Findings Related to Federal Awards²³

12.35 Section 510(a) of Circular A-133, as amended, states that the auditor should report as audit findings in the federal awards section of the schedule of findings and questioned costs:

- a. Significant deficiencies in the internal control over major programs. The auditor's determination of whether a deficiency in internal control is a significant deficiency for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or to an audit objective identified in the *Compliance Supplement*. The auditor should identify significant deficiencies that are individually or cumulatively material weaknesses. (Chapter 9 of this guide discusses significant deficiencies and material weaknesses related to federal programs.)
- b. Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *Compliance Supplement*. (Chapter 10 of this guide further discusses the evaluation and reporting of noncompliance.)
- c. Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor should consider the best estimate of the total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor also should report (in the schedule of findings and questioned costs) known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, estimates that the total questioned costs are

²³ See footnote 22 at the heading before paragraph 12.33.

in the \$50,000 to \$60,000 range, the auditor should report a finding that identifies the known questioned costs of \$7,000. Although the auditor is not required to report his or her estimate of the total questioned costs, the auditor should include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- d. Known questioned costs that are greater than \$10,000 for programs that are not audited as major. Because (except for audit follow-up) the auditor is not required to perform audit procedures for federal programs that are not major, the auditor normally will not find questioned costs. However, if the auditor does become aware of questioned costs for a federal program that is not audited as a major program (for example, as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor should report this as an audit finding.
- e. The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for federal awards (for example, a scope limitation that is not otherwise reported as a finding).
- f. Known fraud affecting a federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for federal awards. Circular A-133 does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing Standards*. (Chapter 4 of this guide discusses the direct reporting requirements of *Government Auditing Standards*.)
- g. Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with section 315(b) of Circular A-133 materially misrepresents the status of any prior audit finding. (See paragraphs 12.41–43.)

Findings of Abuse

12.36 Paragraph 5.15 of *Government Auditing Standards* states that auditors should report, as applicable to the objectives of the audit, abuse that is either quantitatively or qualitatively material. That standard, like all of the general, fieldwork, and reporting standards in *Government Auditing Standards*, applies to the entirety of the A-133 audit, including the compliance audit. As discussed in Chapter 10 of this guide, situations or transactions involving federal awards that might otherwise appear to constitute abuse instead generally are instances of noncompliance. However, there may be isolated situations or transactions involving federal awards that the auditor becomes aware of that do constitute abuse. For abuse involving federal awards that is material to the financial statement amounts,²⁴ the auditor should present the finding in the financial statement section of the schedule of findings and questioned costs and refer to it from the *Government Auditing Standards* report. For abuse involving federal awards that is material to a major program, the auditor should

²⁴ See footnote 13.

present the finding in the federal awards section of the schedule of findings and questioned costs and refer to it from the Circular A-133 report. (Chapter 4 of this guide provides guidance for the placement of the reference from the *Government Auditing Standards* report to abuse findings based on the primary nature of the finding. That guidance also applies in referring to findings of abuse involving federal awards in the Circular A-133 report.) As discussed in paragraph 12.32c, the auditor should report abuse findings that relate to both the financial statements and the federal awards in both sections of the schedule. Those findings may be presented in detail in one section and in summary form in the other section, with a cross-reference to the detailed presentation. If there are abuse findings reported in the federal awards section of the schedule of findings and questioned costs that do not otherwise meet the Circular A-133 requirements for reporting as findings as discussed in paragraph 12.35, the auditor should consider the need to modify both (a) the report on compliance with requirements applicable to each major program and on internal control over compliance and (b) the summary of the auditor's results section of the schedule of findings and questioned costs.

Detail of Audit Findings—Federal Awards

12.37 Section 510(b) of Circular A-133 states that audit findings should be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for federal agencies and pass-through entities to arrive at a management decision. The following specific information should be included according to Circular A-133 (as applicable):

- a. Identification of the federal program and specific federal award, including:
 - The *Catalog of Federal Domestic Assistance* (CFDA) title and number
 - The federal award number and year
 - The name of the federal agency
 - The name of the applicable pass-through entity

When information such as the CFDA title and number or the federal award number is not available, the auditor should provide the best information available to describe the federal award. (Chapter 7 of this guide discusses an alternative for presentation if a CFDA number is not available.)

- b. The criteria or specific requirement upon which the audit finding is based, including the statutory, regulatory, or other citation.
- c. The condition found, including facts that support the deficiency identified in the audit finding.
- d. Identification of questioned costs and how they were computed.
- e. Information to provide a proper perspective for judging the prevalence and consequences of the audit findings, (for example, whether the audit findings represent an isolated instance or a systemic problem). Where appropriate, the instances identified should be related to the universe and the number of cases examined and be quantified in terms of the dollar value.
- f. The possible asserted effect to provide sufficient information to the auditee and federal agency (or pass-through entity, in the case of a

subrecipient) to permit them to determine the cause and effect, to facilitate prompt and proper corrective action.

- g. Recommendations to prevent future occurrences of the deficiency identified in the audit finding.

12.38 Audit findings related to federal awards also should meet the presentation requirements of *Government Auditing Standards*. Chapter 4 of this guide discusses the details that *Government Auditing Standards* requires be reported for findings. That chapter also discusses the requirements in paragraph 4.17 of *Government Auditing Standards* that the elements of a finding include the cause, as well as paragraphs 5.32–.38 of *Government Auditing Standards* that the auditor obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, including planned corrective actions.²⁵ Therefore, even though not specifically discussed in Circular A-133, the auditor should include as an element of each finding the cause of the finding. Further, the auditor should report management views and planned corrective actions for findings related to federal awards in the federal awards section of the schedule of findings and questioned costs. Alternatively, depending on the status of the development of the corrective action plan at the time the auditor's reports are released, the auditor may be able to refer to the corrective action plan as the required presentation of the auditee's views and planned corrective actions.

Other Preparation Guidance

12.39 Each audit finding in the schedule of findings and questioned costs should include a reference number to allow for easy referencing of the audit findings during follow-up. One option for assigning reference numbers is to use the fiscal year being audited as the beginning digits of each reference number, followed by a numeric sequence. For example, findings identified and reported in the audit of fiscal year 20X1 would be assigned reference numbers 20X1-1, 20X1-2, and so forth.

12.40 The auditor is required to issue a schedule of findings and questioned costs for every Circular A-133 audit, regardless of whether any findings or questioned costs are noted. That is because Circular A-133 requires that one section of the schedule summarize the audit results. (See paragraphs 12.31–.32.) In a situation in which there are no findings or questioned costs, the auditor should prepare the summary of auditor's results section of the schedule and either omit the other sections or include them, indicating that no matters were reported.

Summary Schedule of Prior Audit Findings and Corrective Action Plan

12.41 The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee should prepare a

²⁵ Paragraph 5.37 of *Government Auditing Standards* states that if the auditee's comments are inconsistent or in conflict with the report's findings, conclusions, or recommendations, and are not, in the auditors' opinion, valid—or when the planned corrective actions do not adequately address the auditors' recommendations—the auditor should state reasons for disagreeing with the comments or planned corrective actions. That requirement subsumes the requirement in section 510(b)(8) of Circular A-133 that audit findings include the views of responsible officials when there is disagreement with the audit findings, to the extent practical.

summary schedule of prior audit findings. The auditee is not required to prepare a summary schedule of prior audit findings if there are no matters reportable therein. The auditee also should prepare a corrective action plan that addresses each of the current-year audit findings.²⁶ The summary schedule of prior audit findings and the corrective action plan, both of which are part of the reporting package, should include the reference numbers the auditor assigns to audit findings in the schedule of findings and questioned costs. This numbering (or other identification) should include the fiscal year in which the finding initially occurred.

12.42 The auditor should follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of section 500(e) of Circular A-133. (Chapter 10 of this guide discusses follow-up procedures.)

12.43 The auditor has no responsibility for the corrective action plan; however, the auditor may be separately engaged by the auditee for assistance in developing appropriate corrective actions in response to audit findings. The auditor may find the auditee's corrective action plan useful in performing follow-up on prior audit findings (in addition to the schedule of prior audit findings) because it may provide an indication of the corrective steps planned by the auditee.

Data Collection Form[†]

12.44 Circular A-133 states that the auditee should complete and sign certain sections of a data collection form that states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. This form is not part of the reporting package. The information required to be included in the form, however, represents a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards.

12.45 The auditor also should complete certain sections of the form, including information on the auditor and information on the results of the financial statement audit and the audit of federal programs. The auditor should sign a

²⁶ Paragraph 5.32 of *Government Auditing Standards* states that the auditor should obtain and report the views of responsible auditee officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions. Paragraphs 12.34 and 12.38 discuss the interaction of that *Government Auditing Standards* requirement and the Circular A-133 requirement that the auditee prepare a corrective action plan.

[†] Circular A-133 was amended by a *Federal Register* Notice on June 26, 2007. In addition to revisions to Circular A-133, this notice provided instructions on how to address internal control terminology in the Data Collection Form (Form SF-SAC) that is consistent with the terminology in AU section 325A. It also stated that the Form SF-SAC approved for audits with fiscal period end dates in 2004, 2005, and 2006 was extended to apply to audits with fiscal period end dates in 2007. Because the 2004-2006 version of Form SF-SAC had not yet been updated for the updated internal control terminology, the notice stated that any *significant deficiency* should be recorded under the term reportable condition on the following items: Part II, items 3 and 4; Part III, items 4 and 5; and Part 3, item 10 (a). The Form SF-SAC terminology will be updated in the next revision to Form SF-SAC scheduled to be issued on or before August 30, 2008 and applicable for audits with fiscal period end dates of 2008, 2009, and 2010.

statement in the form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package, and that the content of the form is limited to the data elements prescribed by the OMB. As part of completing the form, the auditor is asked to date it. The date that is entered by the auditor should be the date on which he or she completes and signs the form. The wording of the auditor's statement section of the form indicates that no additional procedures were performed since the date of the audit reports. This wording releases the auditor from any subsequent-event responsibility with regard to the timing of the completion of the form and the completion of the audit. For more information see the detailed instructions to Form SF-SAC.

12.46 The data collection form and related instructions are available from the FAC's Web site at <http://harvester.census.gov/sac> or by calling the FAC at (888) 222-9907. The form number is SF-SAC.²⁷ The FAC prefers to receive the data collection form via an online Internet Data Entry System (IDES). The main benefit of using the IDES is that an edit function built directly into the FAC's system identifies certain errors that may have been made in completing the form. This allows both auditors and auditees to correct errors before submitting the form. Once the form is completed and has passed all of the edits, the entity is able to submit the data electronically. The IDES then allows the entity to print a hard copy of the form to be signed and dated by both the auditor and auditee and sent to the FAC along with the appropriate number of reporting packages. Alternatively, the signed form also may be converted to a PDF version using Adobe® Acrobat® and included as a separate file on a CD-ROM that includes the reporting package, as discussed further below. The FAC Web site provides instructions for completing the online submission.

Submission of Reporting Package and Data Collection Form

12.47 The auditee is responsible for submitting the data collection form and the reporting package, including the auditor's reports. The auditee should submit the data collection form and the reporting package within the earlier of 30 days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit.

Submission to Clearinghouse[‡]

12.48 All auditees should submit to the FAC a single copy of the data collection form (Form SF-SAC) and the reporting package as described in

²⁷ The OMB periodically revises the data collection form and its accompanying instructions. Auditors should exercise caution to make sure they use the version of the form and instructions that applies to the fiscal year audited. See also footnote † at the beginning of this section.

[‡] The *Federal Register* Notice issued on June 26, 2007, amending Circular A-133 states "Due to technology advances, starting January 1, 2007, the auditee is no longer required to submit multiple copies of the reporting package to the Federal Audit Clearinghouse (FAC), in accordance with section 320(d) of Circular A-133. However, Part III, item 8, of the Form SF-SAC should continue to be completed noting all agencies required to receive a copy of the reporting package." Also, the 2008-2010 version of the Form SF-SAC is expected to be issued on or before August 30, 2008, and is expected to be accompanied by an announcement from OMB and the FAC establishing an entirely electronic submission process of both Form SF-SAC and the reporting package. (See also footnote † earlier in this section.) Watch the AICPA Governmental Audit Quality Center (www.aicpa.org/GAQC) for further updates on revisions to Form SF-SAC and news on electronic submission.

paragraph 12.05. Alternatively, the reporting package may be converted to a PDF version and included as a single file on a CD-ROM. The auditee should submit one CD-ROM to the FAC, and the FAC will produce copies for the appropriate federal agencies. The FAC Web site includes instructions for CD-ROM submissions.

Submission by Subrecipients

12.49 In addition to the submission requirements discussed in paragraph 12.48, auditees that also are subrecipients should submit to each pass-through entity one copy of the reporting package when the schedule of findings and questioned costs disclosed audit findings related to federal awards that the pass-through entity provided or when the summary schedule of prior audit findings reported the status of any audit findings related to federal awards that the pass-through entity provided. When a subrecipient is not required to submit a reporting package to a pass-through entity, the subrecipient instead should provide written notification to the pass-through entity that:

- An audit of the subrecipient was conducted in accordance with Circular A-133 (including the period covered by the audit and the name, amount, and CFDA number of the federal awards provided by the pass-through entity).
- The schedule of findings and questioned costs disclosed no audit findings related to the federal awards that the pass-through entity provided.
- The summary schedule of prior audit findings did not report on the status of any audit findings related to the federal awards that the pass-through entity provided.

A subrecipient may submit a copy of the reporting package to a pass-through entity to comply with this notification requirement.

Requests for Copies

12.50 In response to a request by a federal agency or pass-through entity, auditees should submit the appropriate copies of the reporting package and, if requested, a copy of any management letters issued by the auditor.

Report Retention Requirements

12.51 Auditees should keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the FAC. Pass-through entities should keep subrecipients' submissions on file for three years from the date of receipt.

Clearinghouse Address

12.52 Submissions should be mailed to the following address: Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th St., Jeffersonville, IN 47132.

Freedom of Information Act and Similar Laws and Regulations

12.53 Often, federal, state, and local laws and regulations, such as the Freedom of Information Act (U.S. Code title 5, section 552), require governments to release certain documents, including audit reports and management letters of organizations for which the government has oversight responsibilities, to members of the press and the general public. Other laws and regulations require that audit reports of governments be made publicly available. Accordingly, the auditor is cautioned not to include names, Social Security numbers, other personal identification, or other potentially sensitive matters in the body of audit reports or any attached or referenced schedules or letters.

12.54

Appendix A—Illustrative Auditor’s Reports Under Circular A-133

A-1. This appendix contains examples of the report on compliance with requirements applicable to each major program and on internal control over compliance issued under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, as amended, in various circumstances for a single audit as discussed previously in this chapter. The following table lists the illustrative reports. Auditors should exercise professional judgment in any situation not specifically addressed in this guide.

| <i>Example No.</i> | <i>Title</i> |
|--------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 12-1 | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Unqualified Opinion on Compliance and No Material Weaknesses [No Significant Deficiencies in Internal Control Over Compliance Identified]</i>) |
| 12-2 | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Unqualified Opinion on Compliance and Significant Deficiencies in Internal Control Over Compliance Identified</i>) |
| 12-3 | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Qualified Opinion on Compliance and Material Weaknesses in Internal Control Over Compliance Identified</i>) |
| 12-4 | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Significant Deficiencies in Internal Control Over Compliance Identified</i>) |
| 12-5 | Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses in Internal Control Over Compliance Identified</i>) |
| 12-6 | Schedule of Findings and Questioned Costs |

A-2. In a single audit, auditors also are required to issue (a) an opinion (or disclaimer of opinion) on the financial statements and on the supplementary schedule of expenditures of federal awards and (b) a report on internal con-

trol over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*. Appendix A (paragraph 4.51) in chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide and paragraphs 12.13–.14 illustrate those reports. Appendix A (paragraph 13.16) in chapter 13, "Program-Specific Audits," of this guide illustrates the reports issued for a program-specific audit.

Example 12-1

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Unqualified Opinion on Compliance and No Material Weaknesses [No Significant Deficiencies in Internal Control Over Compliance Identified]*)¹

[Addressee]

Compliance²

We have audited the compliance of Example Entity with the types of compliance requirements³ described in the OMB *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,⁴ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

¹ The auditor should use the portions of examples 12-1–12-5 relating to compliance and internal control over compliance that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified significant deficiencies, the compliance section of examples 12-1 or 12-2 should be used along with the internal control section of examples 12-2, 12-3, 12-4, or 12-5. Alternatively, if the auditor will be giving a modified opinion on compliance but has not identified significant deficiencies, the internal control section of this report would be used along with the compliance section of example 12-3, 12-4, or 12-5. See also paragraph 12.36 concerning the need to modify this report if the federal awards section of the schedule of findings and questioned costs includes abuse findings.

² This report sequences the reporting on compliance before the reporting on internal control over compliance. However, the *Government Auditing Standards* reports in appendix A (paragraph 4.51) in chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide sequence the reporting on internal control over financial reporting before the reporting on compliance and other matters. Auditors may present the internal control over compliance and compliance sections of the Circular A-133 and *Government Auditing Standards* reports in whichever sequence better meets their needs.

³ The phrase "types of compliance requirements" used here and elsewhere in this report illustration refers to the first 13 types of compliance requirements (identified as A–M) described in Part 3 of the OMB *Circular A-133 Compliance Supplement* (the *Compliance Supplement*) and each individual special test and provision identified in Part 4 of the *Compliance Supplement* for each major program. When a federal program is not included in the *Compliance Supplement*, the identification of types of compliance requirements that apply and are material to a major program, including special tests and provisions, is made by reviewing the program's contract and grant agreements and referenced laws and regulations.

⁴ The Standards applicable to financial audits are the general, fieldwork, and reporting standards described in chapters 3–5 of *Government Auditing Standards*.

Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 20X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 20X1-3 and 20X1-6].⁵

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over compliance.

A *control deficiency* in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.⁶

⁵ When there are no such instances of noncompliance identified in the schedule of findings and questioned costs, the last sentence should be omitted.

⁶ As discussed in paragraphs 12.15 and 12.24, there may be instances in which it would be appropriate to report on the schedule of expenditures of federal awards in this report (that is, a separate single audit package is issued). In such a circumstance, a new section should be added immediately following this paragraph. For audits of not-for-profit organizations, the wording of the new section is as follows:

Schedule of Expenditures of Federal Awards

We have audited the basic financial statements of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1. Our audit was

(continued)

Example Entity's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit Example Entity's response and, accordingly, we express no opinion on it.⁷

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.⁸

[*Signature*]

[*Date*]

(footnote continued)

performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

For audits of governmental entities, the wording of this new section is as follows:

Schedule of Expenditures of Federal Awards

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1. Our audit was performed for the purpose of forming our opinions on the financial statements that collectively comprise Example Entity's basic financial statements. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

When reporting on the supplementary information, the auditor should consider the effect of any modifications to the report on the basic financial statements (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors). Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified accordingly. Guidance for reporting in these circumstances is described in paragraphs .09–.11 and .13–.14 of AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1).

⁷ If, as noted in footnote 5, there are no findings referred to in this report (or identified in the schedule of findings and questioned costs), this paragraph should be omitted.

⁸ This paragraph conforms to AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1). See AU section 532 for additional guidance on restricted-use reports.

Example 12-2

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Unqualified Opinion on Compliance and Significant Deficiencies in Internal Control Over Compliance Identified*)⁹

[Addressee]

Compliance¹⁰

We have audited the compliance of Example Entity with the types of compliance requirements¹¹ described in the OMB *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,¹² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 20X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 20X1-3 and 20X1-6].¹³

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning

⁹ See footnote 1.

¹⁰ See footnote 2.

¹¹ See footnote 3.

¹² See footnote 4.

¹³ See footnote 5.

and performing our audit, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies.

A *control deficiency* in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that non-compliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 20X1-7, 20X1-8, and 20X1-9] to be significant deficiencies.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material non-compliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. We did not consider any of the deficiencies described in the accompanying schedule of findings and questioned costs to be material weaknesses.^{14,15}

Example Entity's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit Example Entity's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of, management, [identify the body of individuals charged with governance], others within the entity, [identify the legislative or regulatory body], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.¹⁶

[Signature]

[Date]

¹⁴ If the auditor considers any of the deficiencies described in the accompanying schedule of findings and questioned costs to be material weaknesses in internal control over compliance, the report should identify those material weaknesses. The last sentence of this paragraph should be replaced with language such as the following, as shown in example 12-3: "Of the significant deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs, we consider items [list the reference numbers of the related findings, for example, 20X1-8 and 20X1-9] to be material weaknesses."

¹⁵ See footnote 6.

¹⁶ See footnote 8.

Example 12-3

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Qualified Opinion on Compliance and Material Weaknesses in Internal Control Over Compliance Identified*)¹⁷

[Addressee]

Compliance¹⁸

We have audited the compliance of Example Entity with the types of compliance requirements¹⁹ described in the OMB *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,²⁰ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in item [list the reference numbers of the related findings, for example, 20X1-10 and 20X1-4] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [identify the type(s) of compliance requirement] that are applicable to its [identify the major federal program]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 20X1.²¹

¹⁷ See footnote 1.

¹⁸ See footnote 2.

¹⁹ See footnote 3.

²⁰ See footnote 4.

²¹ When other instances of noncompliance are identified in the schedule of findings and questioned costs as required by Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the following sentence should be added: "The

(continued)

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and others that we consider to be material weaknesses.

A *control deficiency* in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 20X1-7, 20X1-8, and 20X1-9*] to be significant deficiencies.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. Of the significant deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs, we consider items [*list the reference numbers of the related findings, for example 20X1-8 and 20X1-9*] to be material weaknesses.²²

Example Entity's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit Example Entity's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity,

(footnote continued)

results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 20X1-3, and 20X1-6*]."

²² See footnote 6.

[*identify the legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.²³

[*Signature*]

[*Date*]

²³ See footnote 8.

Example 12-4

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Significant Deficiencies in Internal Control Over Compliance Identified*)^{24,25}

[Addressee]

Compliance²⁶

We have audited the compliance of Example Entity with the types of compliance requirements²⁷ described in the OMB *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in Government Auditing Standards,²⁸ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

We were unable to obtain sufficient documentation supporting the compliance of Example Entity with [identify the major federal program] regarding [identify the type(s) of compliance requirement], nor were we able to satisfy ourselves as to Example Entity's compliance with those requirements by other auditing procedures.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding Example Entity's compliance with the requirements of [identify the major federal program] regarding [identify the type(s) of compliance requirement], Example Entity complied, in all material respects, with the requirements referred

²⁴ See footnote 1.

²⁵ Although this report identifies a significant deficiency, circumstances may warrant a material weakness to be reported.

²⁶ See footnote 2.

²⁷ See footnote 3.

²⁸ See footnote 4.

to above that are applicable to each of its major federal programs for the year ended June 30, 20X1.²⁹

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies.

A *control deficiency* in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 20X1-7, 20X1-8, and 20X1-9*] to be significant deficiencies.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. We did not consider any of the deficiencies described in the accompanying schedule of findings and questioned costs to be material weaknesses.^{30,31}

Example Entity's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit Example Entity's response and, accordingly, we express no opinion on it.

²⁹ See footnote 21.

³⁰ If the auditor considers any of the deficiencies described in the accompanying schedule of findings and questioned costs to be material weaknesses in internal control over compliance, the report should identify those material weaknesses. The last sentence of this paragraph should be replaced with language such as the following, as shown in example 12-3: "Of the significant deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs, we consider items [*list the reference numbers of the related findings, for example, 20X1-8 and 20X1-9*] to be material weaknesses."

³¹ See footnote 6.

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.³²

[*Signature*]

[*Date*]

³² See footnote 8.

Example 12-5

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (*Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses in Internal Control Over Compliance Identified*)³³

[Addressee]

Compliance³⁴

We have audited the compliance of Example Entity with the types of compliance requirements³⁵ described in the OMB *Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 20X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,³⁶ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in items [list the reference numbers of the related findings, for example, 20X1-10, 20X1-11, and 20X1-12] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [identify the types of compliance requirements] that are applicable to its [identify the major federal program]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with requirements applicable to that program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, Example Entity did not comply in all material respects, with the requirements referred to above that are applicable to [identify the major federal program]. Also, in our opinion, Example Entity complied, in all

³³ See footnote 1.

³⁴ See footnote 2.

³⁵ See footnote 3.

³⁶ See footnote 4.

material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 20X1.³⁷

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined below. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and others that we consider to be material weaknesses.

A *control deficiency* in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 20X1-7, 20X1-8, and 20X1-9*] to be significant deficiencies.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control. Of the significant deficiencies in internal control over compliance described in the accompanying schedule of findings and questioned costs, we consider items [*list the reference numbers of the related findings, for example 20X1-8 and 20X1-9*] to be material weaknesses.³⁸

Example Entity's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit Example Entity's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], and federal awarding agencies and

³⁷ See footnote 21.

³⁸ See footnote 6.

pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.³⁹

[*Signature*]

[*Date*]

³⁹ See footnote 8.

Example 12-6

Schedule of Findings and Questioned Costs
Section I—Summary of Auditor's Results

Financial Statements

Type of auditor's report issued [*unqualified, qualified, adverse, or disclaimer*]:⁴⁰

Internal control over financial reporting:

- Material weakness(es) identified? ___ yes ___ no
- Significant deficiency(ies) identified that are not considered to be material weaknesses? ___ yes ___ none reported

Noncompliance material to financial statements noted? ___ yes ___ no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? ___ yes ___ no
- Significant deficiency(ies) identified that are not considered to be material weakness(es)? ___ yes ___ none reported

Type of auditor's report issued on compliance for major programs [*unqualified, qualified, adverse, or disclaimer*]:⁴¹

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of OMB Circular A-133? ___ yes ___ no

Identification of major programs:⁴²

⁴⁰ As explained in the AICPA Audit and Accounting Guide *State and Local Governments*, the auditor generally expresses or disclaims an opinion on a government's basic financial statements by providing an opinion or disclaimer of opinion on each opinion unit required to be presented in those financial statements. Therefore, there could be multiple responses to this question for audits of a government's basic financial statements.

⁴¹ If the audit report for one or more major programs is other than unqualified, indicate the type of report issued for each program. For example, if the audit report on major program compliance for an auditee having five major programs includes an unqualified opinion for three of the programs, a qualified opinion for one program, and a disclaimer of opinion for one program, the response to this question could be as follows: "Unqualified for all major programs except for [*name of program*], which was qualified and [*name of program*], which was a disclaimer."

⁴² Major programs generally should be identified in the same order as reported on the schedule of expenditures of federal awards.

CFDA Number(s)⁴³Name of
Federal
Program or
Cluster⁴⁴

Dollar threshold used to distinguish between
type A and type B programs: \$ _____

Auditee qualified as low-risk auditee? _____ yes _____ no

Section II—Financial Statement Findings

This section should identify the significant deficiencies, material weaknesses, fraud, illegal acts, violations of provisions of contracts and grant agreements, and abuse related to the financial statements for which Government Auditing Standards requires reporting in a Circular A-133 audit. (See paragraphs 12.16 and 12.33.) Auditors should refer to chapter 4 of this guide for a discussion of the Government Auditing Standards requirements for presenting findings.

Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that affects an entity as a whole, including its federal awards, generally would be reported in detail in this section. Section III would then include a summary identification of the finding and a reference back to the specific finding in this section.

Identify each finding with a reference number.⁴⁵ If there are no findings, this section could state that no matters were reported. Alternatively, this section could be omitted without confusing the schedule's users because the summary of auditor's results section would indicate that there are no findings. Each finding should be presented in the level of detail shown in the following listing, as applicable. Auditors also should refer to chapter 4 of this guide for a discussion of the Government Auditing Standards requirements for presenting findings.

- *Criteria or specific requirement*
- *Condition*
- *Context*⁴⁶
- *Effect*
- *Cause*

⁴³ When the *Catalog of Federal Domestic Assistance* (CFDA) number is not available, include other identifying number, if applicable.

⁴⁴ The name of the federal program or cluster should be the same as that listed in the schedule of expenditures of federal awards. For clusters, auditors are required only to list the name of the cluster and not each individual program within the cluster.

⁴⁵ One option for assigning reference numbers is to use the fiscal year being audited as the beginning digits of each reference number, followed by a numeric sequence. For example, findings identified and reported in the audit of fiscal year 20X1 would be assigned reference numbers of 20X1-1, 20X1-2, and so forth.

- Recommendation
- Views of responsible officials and planned corrective actions⁴⁷

Section III—Federal Award Findings and Questioned Costs

This section should identify the audit findings required to be reported by Section 510(a) of Circular A-133 (for example, significant deficiencies, material weaknesses, and material instances of noncompliance, including questioned costs—see paragraph 12.35) as well as any abuse findings involving federal awards that is material to a major program (see paragraph 12.36). Where practical, findings should be organized by federal agency or pass-through entity.

Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a finding of noncompliance with a federal program law that is also material to the financial statements generally would be reported in detail in this section. Section II would then include a summary identification of the finding and a reference back to the specific finding in this section.

Identify each finding with a reference number.⁴⁸ If there are no findings, this section could state that no matters were reported. Alternatively, this section could be omitted without confusing the schedule's users because the summary of auditor's results section would indicate that there are no findings. Each finding should be presented in the level of detail shown in the following listing, as applicable. Auditors also should refer to chapter 4 of this guide for a discussion of the Government Auditing Standards requirements for presenting findings.

- Information on the federal program⁴⁹
- Criteria or specific requirement (including statutory, regulatory, or other citation)
- Condition⁵⁰
- Questioned costs⁵¹
- Context⁵²
- Effect
- Cause
- Recommendation
- Views of responsible officials and planned corrective actions⁵³

⁴⁶ Describe the work performed that resulted in the finding, and provide sufficient information for judging the prevalence and consequences of the finding, such as the relation to the population or universe of costs or the number of cases examined as well as quantification of audit findings in dollars.

⁴⁷ Paragraphs 12.34 and 12.38 and chapter 4 of this guide provide guidance on reporting views of responsible officials and planned corrective action.

⁴⁸ See footnote 45.

⁴⁹ Provide the federal program (CFDA number and title) and agency, the federal award's number and year, and the name of the pass-through entity, if applicable. When this information is not available, the auditor should provide the best information available to describe the federal award.

⁵⁰ Include facts that support the deficiency identified in the audit finding.

⁵¹ Identify questioned costs as required by Sections 510(a)(3) and 510(a)(4) of Circular A-133.

⁵² See footnote 46.

⁵³ See footnote 47.

Chapter 13

Program-Specific Audits

Note: The audit required by the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, is performed in accordance with *Government Auditing Standards*. Part I, "Government Auditing Standards Audits," (Chapters 2–4 of this guide), discusses financial statement audits under generally accepted auditing standards (GAAS) and *Government Auditing Standards*. Auditors who are performing an audit under the Single Audit Act and Circular A-133 should refer to and apply the guidance in part I of this guide in addition to the guidance in part II, "Circular A-133 Audits" (Chapters 5–13 of this guide).

13.01 A program-specific audit is an audit of an individual federal program (rather than a single audit of an entity's financial statements and federal programs). Section 235 of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, provides guidance on program-specific audits.

Use of a Program-Specific Audit to Satisfy Circular A-133 Audit Requirements

13.02 Section 200 of Circular A-133 states that when an auditee expends federal awards under only one federal program (excluding research and development) and the federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit performed in accordance with section 235 of the circular.¹ Therefore, the auditor should determine whether there is a financial statement audit requirement before performing a program-specific audit. A program-specific audit may not be elected for research and development unless all federal awards expended were received from the same federal agency (or the same federal agency and the same pass-through entity) and that federal agency (or pass-through entity, in the case of a subrecipient) approves a program-specific audit in advance.

Program-Specific Audit Requirements

13.03 Circular A-133 states that program-specific audits are subject to the following sections of Circular A-133 as they may apply to program-specific audits, unless contrary to the provisions of section 235 of Circular A-133, a federal program-specific audit guide, or the program's laws and regulations:

¹ An example of a situation where a program-specific audit would not be allowed would be a not-for-profit college that receives student financial aid (SFA) (and no other federal awards). That is because the Higher Education Act of 1965, as amended, requires institutions that receive SFA to undergo an annual financial statement audit.

- Purpose, definitions, audit requirements, basis for determining the federal awards expended, subrecipient and vendor determinations, and relation to other audit requirements (sections 100–215(b))
- Frequency of audits, sanctions, and audit costs (sections 220–230)
- Auditee responsibilities and auditor selection (sections 300–305)
- Follow-up on audit findings (section 315)
- Submission of report (sections 320(f)–320(j))
- Responsibilities of federal agencies and pass-through entities and management decisions (sections 400–405)
- Audit findings and audit working papers (sections 510–515)

Program-specific audits also are subject to other provisions, referred to in section 235 of the Circular.

Availability of Program-Specific Audit Guides

13.04 In many cases, a federal agency's Office of Inspector General will have issued a program-specific audit guide that provides guidance on internal control, compliance requirements, suggested audit procedures, and audit reporting requirements for a particular federal program. The auditor should contact the Office of Inspector General of the federal agency to determine whether such a guide is available and current. When a current program-specific audit guide is available, the auditor should follow *Government Auditing Standards* and the guide when performing a program-specific audit. However, if there have been significant changes made to a program's compliance requirements and the related program-specific audit guide has not been updated with regard to the changes, the auditor should follow section 235 of Circular A-133 and the *OMB Circular A-133 Compliance Supplement (Compliance Supplement)* in lieu of an outdated guide. If a guide is current with regard to a program's compliance requirements but has not been updated to conform to current authoritative auditing standards and requirements (such as current revisions of generally accepted auditing standards [GAAS] or *Government Auditing Standards*), the auditor should follow current applicable professional standards and guidance in lieu of the outdated or inconsistent standards and guidance in the guide.

13.05 When a program-specific audit guide is not available, the auditee and the auditor have basically the same responsibilities for the federal program as they have for an audit of a major program in a single audit as discussed in chapters 9, "Consideration of Internal Control Over Compliance for Major Programs," and 10, "Compliance Auditing Applicable to Major Programs," of this guide. (See also paragraph 13.07 for more information.)

Auditee's Responsibilities When a Program-Specific Audit Guide Is Not Available

13.06 In addition to the responsibilities included in the sections of Circular A-133 that are described in paragraph 13.03, Circular A-133 states that when a program-specific audit guide is not available, the auditor's report should include the following:

- The financial statements for the federal program, which include, at a minimum, a schedule of expenditures of federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule (Chapter 7, "Schedule of Expenditures of Federal Awards," of this guide discusses the schedule.)
- A summary schedule of prior audit findings consistent with the requirements of section 315(b) of Circular A-133 (See chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide.)
- If applicable, a corrective action plan consistent with the requirements of section 315(c) of the Circular (See chapter 12 of this guide.)

Auditor's Responsibilities When a Program-Specific Audit Guide Is Not Available

Audit Scope and Requirements

13.07 When a program-specific audit guide is not available, Circular A-133 states that the auditor should:

- Perform an audit of the financial statement(s) for the federal program in accordance with *Government Auditing Standards*. (Chapters 2, "Planning Considerations of *Government Auditing Standards*," 3, "Financial Statement Audit Considerations of *Government Auditing Standards*," and 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide provide guidance on financial statement audits.) Paragraph 13.10 further discusses the *Government Auditing Standards* report.
- Obtain an understanding of the internal control over compliance and perform tests of the internal control over compliance for the federal program, so that they are consistent with the requirements of section 500(c) of the circular for a major program. (Chapter 9 of this guide provides guidance on the internal control considerations for major programs.)
- Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program consistent with the requirements of section 500(d) of Circular A-133 for a major program. (Chapter 10 of this guide provides guidance on the compliance-auditing considerations for major programs.)
- Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings that has been prepared by the auditee, and when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding, report this as a current-year audit finding, in accordance with the requirements of section 500(e) of Circular A-133. (See chapter 12 of this guide.)

Auditor's Reports

Circular A-133 Requirements

13.08 Circular A-133 states that the auditor's reports may be in the form of either combined or separate reports and may be organized differently from the manner described in Circular A-133 and as listed in this paragraph. The auditor's reports should state that the audit was conducted in accordance with Circular A-133. Because the audit is also subject to GAAS reporting requirements and *Government Auditing Standards*, the report should also include a reference to auditing standards generally accepted in the United States of America and *Government Auditing Standards*. The auditor's reports should include the following:

- An opinion (or disclaimer of opinion) on whether the financial statement(s) of the federal program are presented fairly in all material respects in conformity with the stated accounting policies
- A report on the internal control related to the federal program, which should describe the scope of the testing of the internal control and the results of the tests
- A report on compliance, which includes an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program
- A schedule of findings and questioned costs for the federal program that includes a summary of the auditor's results relative to the audit of the federal program in a format consistent with the requirements for the summary of auditor's results in section 505(d)(1) of Circular A-133, as well as findings and questioned costs for federal awards consistent with the requirements of section 505(d)(3) of the circular (See chapter 12 of this guide.)²

Recommended Auditor's Reports

13.09 In an effort to make program-specific audit reporting understandable and to reduce the number of reports issued, this guide recommends that the following reports be issued for a program-specific audit (a) an opinion (or disclaimer of opinion) on the financial statement(s) of the federal program and (b) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under Circular A-133. Paragraph 13.10 discusses the possible issuance of a third report to meet the reporting requirements of *Government Auditing Standards*. Appendix A (paragraph 13.16) illustrates program-specific

² As discussed in chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide, the schedule of findings and questioned costs also should meet the presentation requirements of *Government Auditing Standards* and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions.

audit reports. Chapters 4 and 12 of this guide discuss the *Government Auditing Standards* requirement that the auditor communicate certain matters to officials of the audited entity in writing.

Reporting in Accordance With Government Auditing Standards

13.10 If the financial statement(s) of the program present only the activity of the federal program, the auditor is not required to issue a separate report to meet the reporting requirements of *Government Auditing Standards*. This is because, in many cases, by definition the financial statements of the program consist only of the schedule of expenditures of federal awards. In this situation, the program-specific audit reports in appendix A (paragraph 13.16) would meet the financial, compliance, and internal control over compliance reporting requirements of both *Government Auditing Standards* and Circular A-133. However, the auditor always has the option of issuing a separate *Government Auditing Standards* report (in addition to the two reports described in paragraph 13.09). In situations when the auditor is engaged to perform a separate engagement, in addition to the program-specific audit (for example, a financial statement audit in accordance with *Government Auditing Standards*), the appropriate audit reports should be issued including a separate *Government Auditing Standards* report. Chapter 4 in this guide discusses the *Government Auditing Standards* report and appendix A (paragraph 4.51) in that chapter illustrates the *Government Auditing Standards* report.

Evaluating and Reporting Abuse

13.11 Chapters 9, 10, and 12 of this guide discuss the *Government Auditing Standards* requirements for evaluating and reporting abuse in a Circular A-133 audit. Auditors who report abuse findings should consider the need to modify the auditor's reports to refer to those findings.

Submission of Report

Timing of Submission

13.12 Circular A-133 states that the audit should be completed and the reporting required by sections 235(c)(2) and 235(c)(3) of the circular be submitted within the earlier of 30 days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the federal agency that provided the funding or unless a different period is specified in a program-specific audit guide. Circular A-133 also states that unless restricted by law or regulation, the auditee should make copies of the report available for public inspection.

Submission When a Program-Specific Audit Guide Is Available

13.13 When a program-specific audit guide is available, the auditee should submit to the Federal Audit Clearinghouse (FAC) the data collection form prepared in accordance with section 320(b) of the circular, as applicable for a program-specific audit, and also submit the reporting that is required by the program-specific audit guide to be retained as an archival copy. (Chapter 12 of this guide provides guidance on the FAC and the data collection form.) The auditee also should submit to the federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

Submission When a Program-Specific Audit Guide Is Not Available

13.14 When a program-specific audit guide is not available, the reporting package for a program-specific audit consists of the following:

- The financial statement(s) of the federal program
- A summary schedule of prior audit findings (See chapter 12 of this guide.)
- A corrective action plan (See chapter 12 of this guide.)
- The auditor's report(s) described in paragraphs 13.08–.10

13.15 Circular A-133 states that the auditee should submit a single copy of the data collection form, as applicable to a program-specific audit, and one copy of the reporting package to the FAC, as discussed in chapter 12 of this guide. Please refer to the "Data Collection Form" section beginning at paragraph 12.44 for specific instructions related to the submission of Form SF-SAC under the amended Circular A-133. (Chapter 12 of this guide also discusses the alternative to submit the reporting package and data collection form on CD-ROM.) When a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient should provide written notification to the pass-through entity, consistent with the requirements of section 320(e)(2) of Circular A-133, as discussed in chapter 12 of this guide. A subrecipient may submit a copy of the reporting package to the pass-through entity to comply with the notification requirement.

13.16

Appendix A—Illustrative Auditor’s Reports for Program-Specific Audits

A-1. This appendix contains examples of the reports issued under OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, for a program-specific audit as discussed previously in this chapter. The following table lists the illustrative reports. Auditors should exercise professional judgment in any situation not specifically addressed in this guide. (As discussed in paragraph 13.10, the auditor should, in certain circumstances, issue these program-specific audit reports as well as a separate *Government Auditing Standards* report. Appendix A [paragraph 4.51] in chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide illustrates the *Government Auditing Standards* report.)

| <i>Example No.</i> | <i>Title</i> |
|--------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 13-1 | Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 |
| 13-2 | Report on Compliance with Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 (<i>Unqualified Opinion on Compliance and No Material Weaknesses [No Significant Deficiencies Identified]</i>) |

Example 13-1

Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 Independent Auditor's Report

We have audited the accompanying schedule of expenditures of federal awards for the [identify the federal program] of Example Entity for the year ended June 30, 20X1. This financial statement is the responsibility of Example Entity's management. Our responsibility is to express an opinion on the financial statement of the program based on our audit.¹

We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of expenditures of federal awards referred to above³ presents fairly, in all material respects, the expenditures of federal awards under the [identify the federal program] in conformity with accounting principles generally accepted in the United States of America.^{4,5}

[Signature]

[Date]

¹ In many cases, the financial statements of the program consist only of the schedule of expenditures of federal awards (and notes to the schedule), which is the minimum financial statement presentation required by section 235 of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. If the auditee issues financial statements that consist of more than the schedule, this paragraph should be modified to describe the financial statements. Paragraph 13.10 discusses the possible need to issue a separate report to meet the reporting requirements of *Government Auditing Standards*.

² The standards applicable to financial audits are the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

³ If the auditee issues financial statements that consist of more than the schedule, this sentence should be modified to identify the results displayed in the financial presentation.

⁴ AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance when the auditee prepares the financial statement of the program in conformity with a basis of accounting other than generally accepted accounting principles (GAAP).

⁵ If a separate report is issued to meet the reporting requirements of *Government Auditing Standards* (see paragraph 13.10), an additional paragraph should be added after the opinion paragraph as follows:

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example Entity's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide opinions on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The second sentence of this paragraph should be modified if the auditor is providing an opinion on internal control over financial reporting or on compliance.

Example 13-2

Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133⁶ (Unqualified Opinion on Compliance and No Material Weaknesses [No Significant Deficiencies Identified])⁷

[Addressee]

Compliance⁸

We have audited the compliance of Example Entity with the types of compliance requirements described in the U.S. OMB *Circular A-133 Compliance Supplement* that are applicable to [identify the federal program] for the year ended June 30, 20X1. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,⁹ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on [identify the federal program] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to its [identify the federal program] for the year ended June 30, 20X1. However, the results of our

⁶ This is an example of a report on a program-specific audit under Circular A-133 when no federal audit guide applicable to the program being audited is available. When a federal audit guide applicable to the program is available, Circular A-133 requires that the auditor follow the reporting requirements of that federal audit guide. (Paragraph 13.04 discusses the auditor's responsibility when a program-specific audit guide is not current.)

⁷ If issuing a qualified or adverse opinion on compliance, the auditor should modify the compliance section of this report to be consistent with the wording used in examples 12-2–12-5 in appendix A in chapter 12, "Auditor Reporting Requirements and Other Communication Considerations in a Single Audit," of this guide. If reporting significant deficiencies, including material weaknesses, the auditor also should modify the internal control section of this report to be consistent with the wording used in those examples. See also paragraph 13.11 concerning the need to modify this report if the schedule of findings and questioned costs includes abuse findings.

⁸ This report sequences the reporting on compliance before the reporting on internal control over compliance. However, the *Government Auditing Standards* reports in appendix A (paragraph 4.51) in chapter 4, "Auditor Reporting Requirements and Other Communication Considerations of *Government Auditing Standards*," of this guide sequence the reporting on internal control over financial reporting before the reporting on compliance and other matters. Auditors may present the internal control and compliance sections of the Circular A-133 and *Government Auditing Standards* reports in whichever sequence better meets their needs.

⁹ See footnote 2.

auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 20X1-1 and 20X1-2*].¹⁰

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on its [*identify the federal program*] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Entity's internal control over compliance.

A *control deficiency* in an entity's internal control over compliance exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect noncompliance with a type of compliance requirement of a federal program on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected by the entity's internal control.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

Example Entity's response to the findings identified in our audit are described in the accompanying schedule of findings and questioned costs. We did not audit Example Entity's response and, accordingly, we express no opinion on it.¹¹

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], and federal awarding agency and

¹⁰ When there are no such instances of noncompliance identified in the schedule of findings and questioned costs, the last sentence should be omitted.

¹¹ If there are no findings referred to in this report (or identified in the schedule of findings and questioned costs), this paragraph should be omitted.

pass-through entity and is not intended to be and should not be used by anyone other than these specified parties.¹²

[*Signature*]

[*Date*]

¹² This paragraph conforms to AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1). See AU section 532 for additional guidance on restricted-use reports.

Appendix A

Single Audit Act Amendments of 1996

Public Law 104-156
104th Congress

An Act

July 5, 1996
[S. 1579]

To streamline and improve the effectiveness of chapter 75 of title 31, United States Code (commonly referred to as the "Single Audit Act").

Single Audit Act
Amendments
of 1996.
31 USC 7501
note.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; PURPOSES.

- (a) Short Title—This Act may be cited as the "Single Audit Act Amendments of 1996".
- (b) Purposes—The purposes of this Act are to—
- (1) promote sound financial management, including effective internal controls, with respect to Federal awards administered by non-Federal entities;
 - (2) establish uniform requirements for audits of Federal awards administered by non-Federal entities;
 - (3) promote the efficient and effective use of audit resources;
 - (4) reduce burdens on State and local governments, Indian tribes, and nonprofit organizations; and
 - (5) ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as amended by this Act).

SEC. 2 . AMENDMENT TO TITLE 31, UNITED STATES CODE.

Chapter 75 of title 31, United States Code, is amended to read as follows:

"CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS

"Sec.

"7501. Definitions.

"7502. Audit requirements; exemptions.

"7503. Relation to other audit requirements.

"7504. Federal agency responsibilities and relations with non-Federal entities.

"7505. Regulations.

"7506. Monitoring responsibilities of the Comptroller General.

"7507. Effective date.

"§ 7501. Definitions

"(a) As used in this chapter, the term—

"(1) 'Comptroller General' means the Comptroller General of the United States;

"(2) 'Director' means the Director of the Office of Management and Budget;

"(3) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5;

"(4) 'Federal awards' means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities;

"(5) 'Federal financial assistance' means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals in accordance with guidance issued by the Director;

"(6) 'Federal program' means all Federal awards to a non-Federal entity assigned a single number in the Catalog of Federal Domestic Assistance or encompassed in a group of numbers or other category as defined by the Director;

"(7) 'generally accepted government auditing standards' means the government auditing standards issued by the Comptroller General;

"(8) 'independent auditor' means—

"(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards; or

"(B) a public accountant who meets such independence standards;

"(9) 'Indian tribe' means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians;

"(10) 'internal controls' means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

"(A) Effectiveness and efficiency of operations.

"(B) Reliability of financial reporting.

"(C) Compliance with applicable laws and regulations;

"(11) 'local government' means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, any other instrumentality of local government and, in accordance with guidelines issued by the Director, a group of local governments;

"(12) 'major program' means a Federal program identified in accordance with risk-based criteria prescribed by the Director under this chapter, subject to the limitations described under subsection (b);

"(13) 'non-Federal entity' means a State, local government, or nonprofit organization;

"(14) 'nonprofit organization' means any corporation, trust, association, cooperative, or other organization that—

"(A) is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;

"(B) is not organized primarily for profit; and

"(C) uses net proceeds to maintain, improve, or expand the operations of the organization;

"(15) 'pass-through entity' means a non-Federal entity that provides Federal awards to a subrecipient to carry out a Federal program;

"(16) 'program-specific audit' means an audit of one Federal program;

"(17) 'recipient' means a non-Federal entity that receives awards directly from a Federal agency to carry out a Federal program;

"(18) 'single audit' means an audit, as described under section 7502(d), of a non-Federal entity that includes the entity's financial statements and Federal awards;

"(19) 'State' means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American

Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe; and

"(20) 'subrecipient' means a non-Federal entity that receives Federal awards through another non-Federal entity to carry out a Federal program, but does not include an individual who receives financial assistance through such awards.

"(b) In prescribing risk-based program selection criteria for major programs, the Director shall not require more programs to be identified as major for a particular non-Federal entity, except as prescribed under subsection (c) or as provided under subsection (d), than would be identified if the major programs were defined as any program for which total expenditures of Federal awards by the non-Federal entity during the applicable year exceed—

"(1) the larger of \$30,000,000 or 0.15 percent of the non-Federal entity's total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$10,000,000,000;

"(2) the larger of \$3,000,000, or 0.30 percent of the non-Federal entity's total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$100,000,000 but are less than or equal to \$10,000,000,000; or

"(3) the larger of \$300,000, or 3 percent of such total Federal expenditures for all programs, in the case of a non-Federal entity for which such total expenditures for all programs equal or exceed \$300,000 but are less than or equal to \$100,000,000.

"(c) When the total expenditures of a non-Federal entity's major programs are less than 50 percent of the non-Federal entity's total expenditures of all Federal awards (or such lower percentage as specified by the Director), the auditor shall select and test additional programs as major programs as necessary to achieve audit coverage of at least 50 percent of Federal expenditures by the non-Federal entity (or such lower percentage as specified by the Director), in accordance with guidance issued by the Director.

"(d) Loan or loan guarantee programs, as specified by the Director, shall not be subject to the application of subsection (b).

"§ 7502. Audit requirements; exemptions

"(a)(1)(A) Each non-Federal entity that expends a total amount of Federal awards equal to or in excess of \$300,000 or such other amount specified by the Director under subsection (a)(3) in any fiscal year of such non-Federal entity shall have either a single audit or a program-specific audit made for such fiscal year in accordance with the requirements of this chapter.

(B) Each such non-Federal entity that expends Federal awards under more than one Federal program shall undergo a single audit in accordance with the requirements of subsections (b) through (i) of this section and guidance issued by the Director under section 7505.

"(C) Each such non-Federal entity that expends awards under only one Federal program and is not subject to laws, regulations, or Federal award agreements that require a financial statement audit of the non-Federal entity, may elect to have a program-specific audit conducted in accordance with applicable provisions of this section and guidance issued by the Director under section 7505.

(2)(A) Each non-Federal entity that expends a total amount of Federal awards of less than \$300,000 or such other amount specified by the Director under subsection (a)(3) in any fiscal year of such entity, shall be exempt for such fiscal year from compliance with

(i) the audit requirements of this chapter; and

(ii) any applicable requirements concerning financial audits contained in Federal statutes and regulations governing programs under which such Federal awards are provided to that non-Federal entity.

"(B) The provisions of subparagraph (A)(ii) of this paragraph shall not exempt a non-Federal entity from compliance with any provision of a Federal statute or regulation that requires such non-Federal entity to maintain records concerning Federal awards provided to such non-Federal entity or that permits a Federal agency, pass-through entity, or the Comptroller General access to such records.

"(3) Every 2 years, the Director shall review the amount for requiring audits prescribed under paragraph (1)(A) and may adjust such dollar

amount consistent with the purposes of this chapter, provided the Director does not make such adjustments below \$300,000.

"(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

"(2) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

"(3) Any nonprofit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

"(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally accepted government auditing standards, except that, for the purposes of this chapter, performance audits shall not be required except as authorized by the Director.

"(d) Each single audit conducted pursuant to subsection (a) for any fiscal year shall

"(1) cover the operations of the entire non-Federal entity;

or

"(2) at the option of such non-Federal entity such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and organizational unit, which shall be considered to be a non-Federal entity.

"(e) The auditor shall—

"(1) determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles;

"(2) determine whether the schedule of expenditures of Federal awards is presented fairly

in all material respects in relation to the financial statements taken as a whole;

"(3) with respect to internal controls pertaining to the compliance requirements for each major program—

"(A) obtain an understanding of such internal controls;

"(B) assess control risk; and

"(C) perform tests of controls unless the controls are deemed to be ineffective; and

"(4) determine whether the non-Federal entity has complied with the provisions of laws, regulations, and contracts or grants pertaining to Federal awards that have a direct and material effect on each major program.

"(f)(1) Each Federal agency which provides Federal awards to a recipient shall—

"(A) provide such recipient the program names (and any identifying numbers) from which such awards are derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter; and

"(B) review the audit of a recipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the recipient by the Federal agency.

"(2) Each pass-through entity shall—

"(A) provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

"(B) monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

"(C) review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

"(D) require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the

pass-through entity to have such access to the subrecipient's records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

"(g)(1) The auditor shall report on the results of any audit conducted pursuant to this section, in accordance with guidance issued by the Director.

"(2) When reporting on any single audit, the auditor shall include a summary of the auditor's results regarding the non-Federal entity's financial statements, internal controls, and compliance with laws and regulations.

"(h) The non-Federal entity shall transmit the reporting package, which shall include the non-Federal entity's financial statements, schedule of expenditures of Federal awards, corrective action plan defined under subsection (i), and auditor's reports developed pursuant to this section, to a Federal clearinghouse designated by the Director, and make it available for public inspection within the earlier of C

"(1) 30 days after receipt of the auditor's report; or

"(2)(A) for a transition period of at least 2 years after the effective date of the Single Audit Act Amendments of 1996, as established by the Director, 13 months after the end of the period audited; or

(B) for fiscal years beginning after the period specified in subparagraph (A), 9 months after the end of the period audited, or within a longer time frame authorized by the Federal agency, determined under criteria issued under section 7504, when the 9-month time frame would place an undue burden on the non-Federal entity.

"(i) If an audit conducted pursuant to this section discloses any audit findings, as defined by the Director, including material noncompliance with individual compliance requirements for a major program by, or reportable conditions in the internal controls of, the non-Federal entity with respect to the matters described in subsection (e), the non-Federal entity shall submit to Federal officials designated by the Director, a plan for corrective action to eliminate such audit findings or reportable conditions or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(c).

"(j) The Director may authorize pilot projects to test alternative methods of achieving the purposes of this chapter. Such pilot projects may begin only after consultation with the Chair and Ranking Minority Member of the Committee on Governmental Affairs of the Senate and the Chair and Ranking Minority Member of the Committee on Government Reform and Oversight of the House of Representatives.

"§ 7503. Relation to other audit requirements

"(a) An audit conducted in accordance with this chapter shall be in lieu of any financial audit of Federal awards which a non-Federal entity is required to undergo under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal law or regulation, a Federal agency shall rely upon and use that information.

"(b) Notwithstanding subsection (a), a Federal agency may conduct or arrange for additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any non-Federal entity (or subrecipient thereof) to constrain, in any manner, such agency from carrying out or arranging for such additional audits, except that the Federal agency shall plan such audits to not be duplicative of other audits of Federal awards.

"(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or arrange for the conduct of, audits and evaluations of Federal awards, nor limit the authority of any Federal agency Inspector General or other Federal official.

"(d) Subsection (a) shall apply to a non-Federal entity which undergoes an audit in accordance with this chapter even though it is not required by section 7502(a) to have such an audit.

"(e) A Federal agency that provides Federal awards and conducts or arranges for audits of non-Federal entities receiving such awards that are in addition to the audits of non-Federal entities conducted pursuant to this chapter shall, consistent with other applicable law, arrange for funding the full cost of such additional audits. Any such additional audits shall be coordinated with the Federal agency determined under criteria issued under section 7504 to preclude duplication of the audits conducted pursuant to this chapter or other additional audits.

"(f) Upon request by a Federal agency or the Comptroller General, any independent auditor conducting an audit pursuant to this chapter shall

make the auditor's working papers available to the Federal agency or the Comptroller General as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this chapter. Such access to auditor's working papers shall include the right to obtain copies.

"§ 7504. Federal agency responsibilities and relations with non-Federal entities

"(a) Each Federal agency shall, in accordance with guidance issued by the Director under section 7505, with regard to Federal awards provided by the agency—

"(1) monitor non-Federal entity use of Federal awards, and

"(2) assess the quality of audits conducted under this chapter for audits of entities for which the agency is the single Federal agency determined under subsection (b).

"(b) Each non-Federal entity shall have a single Federal agency, determined in accordance with criteria established by the Director, to provide the non-Federal entity with technical assistance and assist with implementation of this chapter.

"(c) The Director shall designate a Federal clearinghouse to—

"(1) receive copies of all reporting packages developed in accordance with this chapter;

"(2) identify recipients that expend \$300,000 or more in Federal awards or such other amount specified by the Director under section 7502(a)(3) during the recipient's fiscal year but did not undergo an audit in accordance with this chapter; and

"(3) perform analyses to assist the Director in carrying out responsibilities under this chapter.

"§ 7505. Regulations

"(a) The Director, after consultation with the Comptroller General, and appropriate officials from Federal, State, and local governments and nonprofit organizations shall prescribe guidance to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such guidance.

"(b)(1) The guidance prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to Federal awards for the cost of audits. Such criteria shall prohibit a non-Federal entity from charging to any Federal awards—

"(A) the cost of any audit which is—

"(i) not conducted in accordance with this chapter;

or

"(ii) conducted in accordance with this chapter when expenditures of Federal awards are less than amounts cited in section 7502(a)(1)(A) or specified by the Director under section 7502(a)(3), except that the Director may allow the cost of limited scope audits to monitor subrecipients in accordance with section 7502(f)(2)(B); and

"(B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

"(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit the percentage of the cost of audits performed pursuant to this chapter charged to Federal awards, to exceed the ratio of total Federal awards expended by such non-Federal entity during the applicable fiscal year or years, to such non-Federal entity's total expenditures during such fiscal year or years.

"(c) Such guidance shall include such provisions 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 audit requirements of this chapter.

"§ 7506. Monitoring responsibilities of the Comptroller General

"(a) The Comptroller General shall review provisions requiring financial audits of non-Federal entities that receive Federal awards that are contained in bills and resolutions reported by the committees of the Senate and the House of Representatives.

"(b) If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chapter, the Comptroller General shall, at the earliest practicable date, notify in writing—

"(1) the committee that reported such bill or resolution; and

"(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

"(B) the Committee on Government Reform and Oversight of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

"§ 7507. Effective date

"This chapter shall apply to any non-Federal entity with respect to any of its fiscal years which begin after June 30, 1996."

31 USC 7501
note.

SEC. 3. TRANSITIONAL APPLICATION

Subject to section 7507 of title 31, United States Code (as amended by section 2 of this Act) the provisions of chapter 75 of such title (before amendment by section 2 of this Act) shall continue to apply to any State or local government with respect to any of its fiscal years beginning before July 1, 1996.

Approved July 5, 1996.

LEGISLATIVE HISTORY—S. 1579 (H.R. 3184)

HOUSE REPORTS: No. 104—607 accompanying H.R. 3184 (Comm. on Government Reform and Oversight).

SENATE REPORTS: No. 104—266 (Comm. On Governmental Affairs).

CONGRESSIONAL RECORD, Vol. 142 (1996):

June 14, considered and passed Senate.

June 18, considered and passed House.

WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS, Vol. 32 (1996):

July 5, Presidential statement.

Appendix B

OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations¹

Augustine T. Smythe,
Acting Director

1. OMB rescinds Circular A-128 June 37, 2003
2. OMB revises Circular A-133 to read as follows:

[Circular No. A-133—Revised]

To the Heads of Executive Departments and Establishments

SUBJECT: Audits of States, Local Governments, and Non-Profit Organizations.

1. *Purpose.* This Circular is issued pursuant to the Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. It sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of States, local governments, and non-profit organizations expending Federal awards.

2. *Authority.* Circular A-133 is issued under the authority of sections 503, 1111, and 7501 *et seq.* of title 31, United States Code, and Executive Orders 8248 and 11541.

3. *Rescission and Supersession.* This Circular rescinds Circular A-128, "Audits of State and Local Governments," issued April 12, 1985, and supersedes the prior Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Institutions," issued April 22, 1996. For effective dates, see paragraph 10.

4. *Policy.* Except as provided herein, the standards set forth in this Circular shall be applied by all Federal agencies. If any statute specifically prescribes policies or specific requirements that differ from the standards provided herein, the provisions of the subsequent statute shall govern.

Federal agencies shall apply the provisions of the sections of this Circular to non-Federal entities, whether they are recipients expending Federal awards received directly from Federal awarding agencies, or are subrecipients expending Federal awards received from a pass-through entity (a recipient or another subrecipient).

This Circular does not apply to non-U.S. based entities expending Federal awards received either directly as a recipient or indirectly as a subrecipient.

5. *Definitions.* The definitions of key terms used in this Circular are contained in § __.105 in the Attachment to this Circular.

¹ This appendix reprints Circular A-133, as revised on June 27, 2003. The Office of Management and Budget (OMB) again revised Circular A-133 on June 26, 2007, to, among other things, adopt terminology from AU section 325A (Statement on Auditing Standards No. 112), *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1). As of the date of the printing of this guide, a complete version of the 2007 revised circular was not available. However, the 2003 version of the circular and the June 26, 2007 *Federal Register* notice that further revised the circular can be obtained from the OMB's Web site at www.omb.gov/grants/grants_circulars.html.

6. *Required Action.* The specific requirements and responsibilities of Federal agencies and non-Federal entities are set forth in the Attachment to this Circular. Federal agencies making awards to non-Federal entities, either directly or indirectly, shall adopt the language in the Circular in codified regulations as provided in Section 10 (below), unless different provisions are required by Federal statute or are approved by the Office of Management and Budget (OMB).

7. *OMB Responsibilities.* OMB will review Federal agency regulations and implementation of this Circular, and will provide interpretations of policy requirements and assistance to ensure uniform, effective and efficient implementation.

8. *Information Contact.* Further information concerning Circular A-133 may be obtained by contacting the Financial Standards and Reporting Branch, Office of Federal Financial Management, Office of Management and Budget, Washington, DC 20503, telephone (202) 395-3993.

9. *Review Date.* This Circular will have a policy review three years from the date of issuance.

10. *Effective Dates.* The standards set forth in §__400 of the Attachment to this Circular, which apply directly to Federal agencies, shall be effective July 1, 1996, and shall apply to audits of fiscal years beginning after June 30, 1996, except as otherwise specified in §__400(a).

The standards set forth in this Circular that Federal agencies shall apply to non-Federal entities shall be adopted by Federal agencies in codified regulations not later than 60 days after publication of this final revision in the **Federal Register**, so that they will apply to audits of fiscal years beginning after June 30, 1996, with the exception that §__305(b) of the Attachment applies to audits of fiscal years beginning after June 30, 1998. The requirements of Circular A-128, although the Circular is rescinded, and the 1990 version of Circular A-133 remain in effect for audits of fiscal years beginning on or before June 30, 1996.

The revisions published in the Federal Register June 27, 2003, are effective for fiscal years ending after December 31, 2003, and early implementation is not permitted with the exception of the definition of oversight agency for audit which is effective July 28, 2003.

Augustine T. Smythe,
Acting Director.
Attachment

PART — AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS

Subpart A—General

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__520 Major program determination.

__525 Criteria for Federal program risk.

__530 Criteria for a low-risk auditee.

Appendix A to Part —Data Collection Form (Form SF-SAC)

Appendix B to Part —Circular A-133 Compliance Supplement

Subpart A—General

§ __100 Purpose.

This part sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of non-Federal entities expending Federal awards.

§ __.105 Definitions.

Auditee means any non-Federal entity that expends Federal awards which must be audited under this part.

Auditor means an auditor, that is a public accountant or a Federal, State or local government audit organization, which meets the general standards specified in generally accepted government auditing standards (GAGAS). The term *auditor* does not include internal auditors of non-profit organizations.

Audit finding means deficiencies which the auditor is required by § __.510(a) to report in the schedule of findings and questioned costs.

CFDA number means the number assigned to a Federal program in the *Catalog of Federal Domestic Assistance(CFDA)*.

Cluster of programs means a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters. "Other clusters" are as defined by the Office of Management and Budget (OMB) in the compliance supplement or as designated by a State for Federal awards the State provides to its subrecipients that meet the definition of a cluster of programs. When designating an "other cluster," a State shall identify the Federal awards included in the cluster and advise the subrecipients of compliance requirements applicable to the cluster, consistent with § __.400(d)(1) and § __.400(d)(2), respectively. A cluster of programs shall be considered as one program for determining major programs, as described in § __.520, and, with the exception of R&D as described in § __.200(c), whether a program-specific audit may be elected.

Cognizant agency for audit means the Federal agency designated to carry out the responsibilities described in § __.400(a).

Compliance supplement refers to the *Circular A-133 Compliance Supplement*, included as Appendix B to Circular A-133, or such documents as OMB or its designee may issue to replace it. This document is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20402-9325.

Corrective action means action taken by the auditee that:

- (1) Corrects identified deficiencies;
- (2) Produces recommended improvements; or
- (3) Demonstrates that audit findings are either invalid or do not warrant auditee action.

Federal agency has the same meaning as the term *agency* in Section 551(1) of title 5, United States Code.

Federal award means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors. Any audits of such vendors shall be covered by the terms and conditions of the contract. Contracts to operate Federal Government owned, contractor operated facilities (GOCOs) are excluded from the requirements of this part.

Federal awarding agency means the Federal agency that provides an award directly to the recipient.

Federal financial assistance means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance, but does not include amounts received as reimbursement for services rendered to individuals as described in § __.205(h) and § __.205(i).

Federal program means:

- (1) All Federal awards to a non-Federal entity assigned a single number in the CFDA.
- (2) When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and considered one program.
- (3) Notwithstanding paragraphs (1) and (2) of this definition, a cluster of programs. The types of clusters of programs are:
 - (i) Research and development (R&D);
 - (ii) Student financial aid (SFA); and
 - (iii) "Other clusters," as described in the definition of cluster of programs in this section.

GAGAS means generally accepted government auditing standards issued by the Comptroller General of the United States, which are applicable to financial audits.

Generally accepted accounting principles has the meaning specified in generally accepted auditing standards issued by the American Institute of Certified Public Accountants (AICPA).

Indian tribe means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

Internal control means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- (1) Effectiveness and efficiency of operations;
- (2) Reliability of financial reporting; and
- (3) Compliance with applicable laws and regulations.

Internal control pertaining to the compliance requirements for Federal programs (Internal control over Federal programs) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for Federal programs:

- (1) Transactions are properly recorded and accounted for to:
 - (i) Permit the preparation of reliable financial statements and Federal reports;
 - (ii) Maintain accountability over assets; and
 - (iii) Demonstrate compliance with laws, regulations, and other compliance requirements;

- (2) Transactions are executed in compliance with:
 - (i) Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program; and
 - (ii) Any other laws and regulations that are identified in the compliance supplement; and
- (3) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Loan means a Federal loan or loan guarantee received or administered by a non-Federal entity.

Local government means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

Major program means a Federal program determined by the auditor to be a major program in accordance with §__.520 or a program identified as a major program by a Federal agency or pass-through entity in accordance with §__.215(c).

Management decision means the evaluation by the Federal awarding agency or pass-through entity of the audit findings and corrective action plan and the issuance of a written decision as to what corrective action is necessary.

Non-Federal entity means a State, local government, or non-profit organization.

Non-profit organization means:

- (1) any corporation, trust, association, cooperative, or other organization that:
 - (i) Is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;
 - (ii) Is not organized primarily for profit; and
 - (iii) Uses its net proceeds to maintain, improve, or expand its operations; and
- (2) The term *non-profit organization* includes non-profit institutions of higher education and hospitals.

OMB means the Executive Office of the President, Office of Management and Budget.

Oversight agency for audit means the Federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit. When there is no direct funding, the Federal agency with the predominant indirect funding shall assume the oversight responsibilities. The duties of the oversight agency for audit are described in §__.400(b).

Effective July 28, 2003, the following is added to this definition:

A Federal agency with oversight for an auditee may reassign oversight to another Federal agency which provides substantial funding and agrees to be the oversight agency for audit. Within 30 days after any reassignment, both the old and the new oversight agency for audit shall notify the auditee, and, if known, the auditor of the reassignment.

Pass-through entity means a non-Federal entity that provides a Federal award to a subrecipient to carry out a Federal program.

Program-specific audit means an audit of one Federal program as provided for in § __.200(c) and § __.235.

Questioned cost means a cost that is questioned by the auditor because of an audit finding:

- (1) Which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds;
- (2) Where the costs, at the time of the audit, are not supported by adequate documentation; or
- (3) Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Recipient means a non-Federal entity that expends Federal awards received directly from a Federal awarding agency to carry out a Federal program.

Research and development (R&D) means all research activities, both basic and applied, and all development activities that are performed by a non-Federal entity. *Research* is defined as a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. The term research also includes activities involving the training of individuals in research techniques where such activities utilize the same facilities as other research and development activities and where such activities are not included in the instruction function. *Development* is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes.

Single audit means an audit which includes both the entity's financial statements and the Federal awards as described in § __.500.

State means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe as defined in this section.

Student Financial Aid (SFA) includes those programs of general student assistance, such as those authorized by Title IV of the Higher Education Act of 1965, as amended, (20 U.S.C. 1070 *et seq.*) which is administered by the U.S. Department of Education, and similar programs provided by other Federal agencies. It does not include programs which provide fellowships or similar Federal awards to students on a competitive basis, or for specified studies or research.

Subrecipient means a non-Federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a recipient of other Federal awards directly from a Federal awarding agency. Guidance on distinguishing between a subrecipient and a vendor is provided in § __.210.

Types of compliance requirements refers to the types of compliance requirements listed in the compliance supplement. Examples include: activities

allowed or unallowed; allowable costs/cost principles; cash management; eligibility; matching, level of effort, earmarking; and, reporting.

Vendor means a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a Federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the Federal program. Additional guidance on distinguishing between a subrecipient and a vendor is provided in §__.210.

Subpart B—Audits

§__.200 Audit requirements.

(a) *Audit required.* Non-Federal entities that expend \$300,000 (\$500,000 for fiscal years ending after December 31, 2003) or more in a year in Federal awards shall have a single or program-specific audit conducted for that year in accordance with the provisions of this part. Guidance on determining Federal awards expended is provided in §__.205.

(b) *Single audit.* Non-Federal entities that expend \$300,000 (\$500,000 for fiscal years ending after December 31, 2003) or more in a year in Federal awards shall have a single audit conducted in accordance with §__.500 except when they elect to have a program-specific audit conducted in accordance with paragraph (c) of this section.

(c) *Program-specific audit election.* When an auditee expends Federal awards under only one Federal program (excluding R&D) and the Federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit conducted in accordance with §__.235. A program-specific audit may not be elected for R&D unless all of the Federal awards expended were received from the same Federal agency, or the same Federal agency and the same pass-through entity, and that Federal agency, or pass-through entity in the case of a subrecipient, approves in advance a program-specific audit.

(d) *Exemption when Federal awards expended are less than \$300,000 (\$500,000 for fiscal years ending after December 31, 2003).* Non-Federal entities that expend less than \$300,000 (\$500,000 for fiscal years ending after December 31, 2003) a year in Federal awards are exempt from Federal audit requirements for that year, except as noted in §__.215(a), but records must be available for review or audit by appropriate officials of the Federal agency, pass-through entity, and General Accounting Office (GAO).

(e) *Federally Funded Research and Development Centers (FFRDC).* Management of an auditee that owns or operates a FFRDC may elect to treat the FFRDC as a separate entity for purposes of this part.

§__.205 Basis for determining Federal awards expended.

(a) *Determining Federal awards expended.* The determination of when an award is expended should be based on when the activity related to the award occurs. Generally, the activity pertains to events that require the non-Federal entity to comply with laws, regulations, and the provisions of contracts or grant agreements, such as: expenditure/expense transactions associated with grants, cost-reimbursement contracts, cooperative agreements, and direct appropriations; the disbursement of funds passed through to subrecipients; the use of loan proceeds under loan and loan guarantee programs; the receipt of property; the receipt of surplus property; the receipt or use of program income; the distribution or consumption of food commodities; the disbursement of amounts

entitling the non-Federal entity to an interest subsidy; and, the period when insurance is in force.

(b) *Loan and loan guarantees (loans)*. Since the Federal Government is at risk for loans until the debt is repaid, the following guidelines shall be used to calculate the value of Federal awards expended under loan programs, except as noted in paragraphs (c) and (d) of this section:

- (1) Value of new loans made or received during the fiscal year; plus
- (2) Balance of loans from previous years for which the Federal Government imposes continuing compliance requirements; plus
- (3) Any interest subsidy, cash, or administrative cost allowance received.

(c) *Loan and loan guarantees (loans) at institutions of higher education*. When loans are made to students of an institution of higher education but the institution does not make the loans, then only the value of loans made during the year shall be considered Federal awards expended in that year. The balance of loans for previous years is not included as Federal awards expended because the lender accounts for the prior balances.

(d) *Prior loan and loan guarantees (loans)*. Loans, the proceeds of which were received and expended in prior-years, are not considered Federal awards expended under this part when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

(e) *Endowment funds*. The cumulative balance of Federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

(f) *Free rent*. Free rent received by itself is not considered a Federal award expended under this part. However, free rent received as part of an award to carry out a Federal program shall be included in determining Federal awards expended and subject to audit under this part.

(g) *Valuing non-cash assistance*. Federal non-cash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property, shall be valued at fair market value at the time of receipt or the assessed value provided by the Federal agency.

(h) *Medicare*. Medicare payments to a non-Federal entity for providing patient care services to Medicare eligible individuals are not considered Federal awards expended under this part.

(i) *Medicaid*. Medicaid payments to a subrecipient for providing patient care services to Medicaid eligible individuals are not considered Federal awards expended under this part unless a State requires the funds to be treated as Federal awards expended because reimbursement is on a cost-reimbursement basis.

(j) *Certain loans provided by the National Credit Union Administration*. For purposes of this part, loans made from the National Credit Union Share Insurance Fund and the Central Liquidity Facility that are funded by contributions from insured institutions are not considered Federal awards expended.

§ .210 Subrecipient and vendor determinations.

(a) *General*. An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient would be subject to audit under this part. The payments received for goods or services provided as a vendor would not be considered Federal awards. The guidance in paragraphs (b)

and (c) of this section should be considered in determining whether payments constitute a Federal award or a payment for goods and services.

(b) *Federal award.* Characteristics indicative of a Federal award received by a subrecipient are when the organization:

- (1) Determines who is eligible to receive what Federal financial assistance;
- (2) Has its performance measured against whether the objectives of the Federal program are met;
- (3) Has responsibility for programmatic decision making;
- (4) Has responsibility for adherence to applicable Federal program compliance requirements; and
- (5) Uses the Federal funds to carry out a program of the organization as compared to providing goods or services for a program of the pass-through entity.

(c) *Payment for goods and services.* Characteristics indicative of a payment for goods and services received by a vendor are when the organization:

- (1) Provides the goods and services within normal business operations;
- (2) Provides similar goods or services to many different purchasers;
- (3) Operates in a competitive environment;
- (4) Provides goods or services that are ancillary to the operation of the Federal program; and
- (5) Is not subject to compliance requirements of the Federal program.

(d) *Use of judgment in making determination.* There may be unusual circumstances or exceptions to the listed characteristics. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present and judgment should be used in determining whether an entity is a subrecipient or vendor.

(e) *For-profit subrecipient.* Since this part does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits.

(f) *Compliance responsibility for vendors.* In most cases, the auditee's compliance responsibility for vendors is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. Program compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions which are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine program compliance. Also, when these vendor transactions relate to a major program, the scope of the audit shall include determining whether these transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements.

§ .215 Relation to other audit requirements.

(a) *Audit under this part in lieu of other audits.* An audit made in accordance with this part shall be in lieu of any financial audit required under individual

Federal awards. To the extent this audit meets a Federal agency's needs, it shall rely upon and use such audits. The provisions of this part neither limit the authority of Federal agencies, including their Inspectors General, or GAO to conduct or arrange for additional audits (e.g., financial audits, performance audits, evaluations, inspections, or reviews) nor authorize any auditee to constrain Federal agencies from carrying out additional audits. Any additional audits shall be planned and performed in such a way as to build upon work performed by other auditors.

(b) *Federal agency to pay for additional audits.* A Federal agency that conducts or contracts for additional audits shall, consistent with other applicable laws and regulations, arrange for funding the full cost of such additional audits.

(c) *Request for a program to be audited as a major program.* A Federal agency may request an auditee to have a particular Federal program audited as a major program in lieu of the Federal agency conducting or arranging for the additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such request by informing the Federal agency whether the program would otherwise be audited as a major program using the risk-based audit approach described in § 520 and, if not, the estimated incremental cost. The Federal agency shall then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon this Federal agency request, and the Federal agency agrees to pay the full incremental costs, then the auditee shall have the program audited as a major program. A pass-through entity may use the provisions of this paragraph for a subrecipient.

§ 220 Frequency of audits.

Except for the provisions for biennial audits provided in paragraphs (a) and (b) of this section, audits required by this part shall be performed annually. Any biennial audit shall cover both years within the biennial period.

(a) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this part biennially. This requirement must still be in effect for the biennial period under audit.

(b) Any non-profit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this part biennially.

§ 225 Sanctions.

No audit costs may be charged to Federal awards when audits required by this part have not been made or have been made but not in accordance with this part. In cases of continued inability or unwillingness to have an audit conducted in accordance with this part, Federal agencies and pass-through entities shall take appropriate action using sanctions such as:

- (a) Withholding a percentage of Federal awards until the audit is completed satisfactorily;
- (b) Withholding or disallowing overhead costs;
- (c) Suspending Federal awards until the audit is conducted; or
- (d) Terminating the Federal award.

§ .230 Audit costs.

(a) *Allowable costs.* Unless prohibited by law, the cost of audits made in accordance with the provisions of this part are allowable charges to Federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB cost principles circulars, the Federal Acquisition Regulation (FAR) (48 CFR parts 30 and 31), or other applicable cost principles or regulations.

(b) *Unallowable costs.* A non-Federal entity shall not charge the following to a Federal award:

- (1) The cost of any audit under the Single Audit Act Amendments of 1996 (31 U.S.C. 7501 *et seq.*) not conducted in accordance with this part.
- (2) The cost of auditing a non-Federal entity which has Federal awards expended of less than \$300,000 (*\$500,000 for fiscal years ending after December 31, 2003*) per year and is thereby exempted under § .200(d) from having an audit conducted under this part. However, this does not prohibit a pass-through entity from charging Federal awards for the cost of limited scope audits to monitor its subrecipients in accordance with § .400(d)(3), provided the subrecipient does not have a single audit. For purposes of this part, limited scope audits only include agreed-upon procedures engagements conducted in accordance with either the AICPA's generally accepted auditing standards or attestation standards, that are paid for and arranged by a pass-through entity and address only one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching; level of effort, earmarking; and, reporting.

§ .235 Program-specific audits.

(a) *Program-specific audit guide available.* In many cases, a program-specific audit guide will be available to provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. The auditor should contact the Office of Inspector General of the Federal agency to determine whether such a guide is available. When a current program-specific audit guide is available, the auditor shall follow GAGAS and the guide when performing a program-specific audit.

(b) *Program-specific audit guide not available.* (1) When a program-specific audit guide is not available, the auditee and auditor shall have basically the same responsibilities for the Federal program as they would have for an audit of a major program in a single audit.

- (2) The auditee shall prepare the financial statement(s) for the Federal program that includes, at a minimum, a schedule of expenditures of Federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule, a summary schedule of prior audit findings consistent with the requirements of § .315(b), and a corrective action plan consistent with the requirements of § .315(c).
- (3) The auditor shall:
 - (i) Perform an audit of the financial statement(s) for the Federal program in accordance with GAGAS;
 - (ii) Obtain an understanding of internal control and perform tests of internal control over the Federal program consistent with the requirements of § .500(c) for a major program;

- (iii) Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the Federal program consistent with the requirements of §__.500(d) for a major program; and
 - (iv) Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of §__.500(e).
- (4) The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:
- (i) An opinion (or disclaimer of opinion) as to whether the financial statement(s) of the Federal program is presented fairly in all material respects in conformity with the stated accounting policies;
 - (ii) A report on internal control related to the Federal program, which shall describe the scope of testing of internal control and the results of the tests;
 - (iii) A report on compliance which includes an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on the Federal program; and
 - (iv) A schedule of findings and questioned costs for the Federal program that includes a summary of the auditor's results relative to the Federal program in a format consistent with §__.505(d)(1) and findings and questioned costs consistent with the requirements of §__.505(d)(3).
- (c) *Report submission for program-specific audits.*
- (1) The audit shall be completed and the reporting required by paragraph (c)(2) or (c)(3) of this section submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the Federal agency that provided the funding or a different period is specified in a program-specific audit guide. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the required reporting shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period, unless a different period is specified in a program-specific audit guide.) Unless restricted by law or regulation, the auditee shall make report copies available for public inspection.
 - (2) When a program-specific audit guide is available, the auditee shall submit to the Federal clearinghouse designated by OMB the data collection form prepared in accordance with §__.320(b), as applicable to a program-specific audit, and the reporting required by the program-specific audit guide to be retained as an archival copy. Also, the auditee shall submit to the Federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

- (3) When a program-specific audit guide is not available, the reporting package for a program-specific audit shall consist of the financial statement(s) of the Federal program, a summary schedule of prior audit findings, and a corrective action plan as described in paragraph (b)(2) of this section, and the auditor's report(s) described in paragraph (b)(4) of this section. The data collection form prepared in accordance with §.320(b), as applicable to a program-specific audit, and one copy of this reporting package shall be submitted to the Federal clearinghouse designated by OMB to be retained as an archival copy. Also, when the schedule of findings and questioned costs disclosed audit findings or the summary schedule of prior audit findings reported the status of any audit findings, the auditee shall submit one copy of the reporting package to the Federal clearinghouse on behalf of the Federal awarding agency, or directly to the pass-through entity in the case of a subrecipient. Instead of submitting the reporting package to the pass-through entity, when a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient shall provide written notification to the pass-through entity, consistent with the requirements of §.320(e)(2). A subrecipient may submit a copy of the reporting package to the pass-through entity to comply with this notification requirement.

(d) *Other sections of this part may apply.* Program-specific audits are subject to §.100 through §.215(b), §.220 through §.230, §.300 through §.305, §.315, §.320(f) through §.320(j), §.400 through §.405, §.510 through §.515, and other referenced provisions of this part unless contrary to the provisions of this section, a program-specific audit guide, or program laws and regulations.

Subpart C—Auditees

§.300 Auditee responsibilities.

The auditee shall:

- (a) Identify, in its accounts, all Federal awards received and expended and the Federal programs under which they were received. Federal program and award identification shall include, as applicable, the CFDA title and number, award number and year, name of the Federal agency, and name of the pass-through entity.
- (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.
- (c) Comply with laws, regulations, and the provisions of contracts or grant agreements related to each of its Federal programs.
- (d) Prepare appropriate financial statements, including the schedule of expenditures of Federal awards in accordance with §.310.
- (e) Ensure that the audits required by this part are properly performed and submitted when due. When extensions to the report submission due date required by §.320(a) are granted by the cognizant or oversight agency for audit, promptly notify the Federal clearinghouse designated by OMB and each pass-through entity providing Federal awards of the extension.

- (f) Follow up and take corrective action on audit findings, including preparation of a summary schedule of prior audit findings and a corrective action plan in accordance with §__315(b) and §__315(c), respectively.

§__305 Auditor selection.

(a) *Auditor procurement.* In procuring audit services, auditees shall follow the procurement standards prescribed by the Grants Management Common Rule (hereinafter referred to as the "A-102 Common Rule") published March 11, 1988 and amended April 19, 1995 [insert appropriate CFR citation], Circular A-110, "Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations," or the FAR (48 CFR part 42), as applicable (OMB Circulars are available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503). Whenever possible, auditees shall make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services as stated in the A-102 Common Rule, OMB Circular A-110, or the FAR (48 CFR part 42), as applicable. In requesting proposals for audit services, the objectives and scope of the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price.

(b) *Restriction on auditor preparing indirect cost proposals.* An auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the audit required by this part when the indirect costs recovered by the auditee during the prior year exceeded \$1 million. This restriction applies to the base year used in the preparation of the indirect cost proposal or cost allocation plan and any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. To minimize any disruption in existing contracts for audit services, this paragraph applies to audits of fiscal years beginning after June 30, 1998.

(c) *Use of Federal auditors.* Federal auditors may perform all or part of the work required under this part if they comply fully with the requirements of this part.

§__310 Financial statements.

(a) *Financial statements.* The auditee shall prepare financial statements that reflect its financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements shall be for the same organizational unit and fiscal year that is chosen to meet the requirements of this part. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits in accordance with §__500(a) and prepare separate financial statements.

(b) *Schedule of expenditures of Federal awards.* The auditee shall also prepare a schedule of expenditures of Federal awards for the period covered by the auditee's financial statements. While not required, the auditee may choose to provide information requested by Federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a Federal program has multiple award years, the auditee may list the amount of Federal awards expended for each award year separately. At a minimum, the schedule shall:

- (1) List individual Federal programs by Federal agency. For Federal programs included in a cluster of programs, list individual Federal programs within a cluster of programs. For R&D, total Federal awards expended shall be shown either by individual award or by Federal agency and major subdivision within the Federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services.
- (2) For Federal awards received as a subrecipient, the name of the pass-through entity and identifying number assigned by the pass-through entity shall be included.
- (3) Provide total Federal awards expended for each individual Federal program and the CFDA number or other identifying number when the CFDA information is not available.
- (4) Include notes that describe the significant accounting policies used in preparing the schedule.
- (5) To the extent practical, pass-through entities should identify in the schedule the total amount provided to subrecipients from each Federal program.
- (6) Include, in either the schedule or a note to the schedule, the value of the Federal awards expended in the form of non-cash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end. While not required, it is preferable to present this information in the schedule.

§ __.315 Audit findings follow-up.

(a) *General.* The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings. The auditee shall also prepare a corrective action plan for current year audit findings. The summary schedule of prior audit findings and the corrective action plan shall include the reference numbers the auditor assigns to audit findings under § __.510(c). Since the summary schedule may include audit findings from multiple years, it shall include the fiscal year in which the finding initially occurred.

(b) *Summary schedule of prior audit findings.* The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards. The summary schedule shall also include audit findings reported in the prior audit's summary schedule of prior audit findings except audit findings listed as corrected in accordance with paragraph (b)(1) of this section, or no longer valid or not warranting further action in accordance with paragraph (b)(4) of this section.

- (1) When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- (2) When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken.
- (3) When corrective action taken is significantly different from corrective action previously reported in a corrective action plan or in the Federal agency's or pass-through entity's management decision, the summary schedule shall provide an explanation.

- (4) When the auditee believes the audit findings are no longer valid or do not warrant further action, the reasons for this position shall be described in the summary schedule. A valid reason for considering an audit finding as not warranting further action is that all of the following have occurred:
- (i) Two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse;
 - (ii) The Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and
 - (iii) A management decision was not issued.

(c) *Corrective action plan.* At the completion of the audit, the auditee shall prepare a corrective action plan to address each audit finding included in the current year auditor's reports. The corrective action plan shall provide the name(s) of the contact person(s) responsible for corrective action, the corrective action planned, and the anticipated completion date. If the auditee does not agree with the audit findings or believes corrective action is not required, then the corrective action plan shall include an explanation and specific reasons.

§ __.320 Report submission.

(a) *General.* The audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the data collection form and reporting package shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period.) Unless restricted by law or regulation, the auditee shall make copies available for public inspection.

(b) *Data Collection.*

- (1) The auditee shall submit a data collection form which states whether the audit was completed in accordance with this part and provides information about the auditee, its Federal programs, and the results of the audit. The form shall be approved by OMB, available from the Federal clearinghouse designated by OMB, and include data elements similar to those presented in this paragraph. A senior level representative of the auditee (e.g., State controller, director of finance, chief executive officer, or chief financial officer) shall sign a statement to be included as part of the form certifying that: the auditee complied with the requirements of this part, the form was prepared in accordance with this part (and the instructions accompanying the form), and the information included in the form, in its entirety, are accurate and complete.
- (2) The data collection form shall include the following data elements:
 - (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.

- (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.
- (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.
- (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
- (vi) A list of the Federal awarding agencies which will receive a copy of the reporting package pursuant to §__.320(d)(2) of the OMB Circular A-133.
- (vii) A yes or no statement as to whether the auditee qualified as a low-risk auditee under §__.530 of the OMB Circular A-133.
- (viii) The dollar threshold used to distinguish between Type A and Type B programs as defined in §__.520(b) of the OMB Circular A-133.
- (ix) The *Catalog of Federal Domestic Assistance* (CFDA) number for each Federal program, as applicable.
- (x) The name of each Federal program and identification of each major program. Individual programs within a cluster of programs should be listed in the same level of detail as they are listed in the schedule of expenditures of Federal awards.
- (xi) The amount of expenditures in the schedule of expenditures of Federal awards associated with each Federal program.
- (xii) For each Federal program, a yes or no statement as to whether there are audit findings in each of the following types of compliance requirements and the total amount of any questioned costs:
 - (A) Activities allowed or unallowed.
 - (B) Allowable costs/cost principles.
 - (C) Cash management.
 - (D) Davis-Bacon Act.
 - (E) Eligibility.
 - (F) Equipment and real property management.
 - (G) Matching, level of effort, earmarking.
 - (H) Period of availability of Federal funds.
 - (I) Procurement and suspension and debarment.
 - (J) Program income.
 - (K) Real property acquisition and relocation assistance.
 - (L) Reporting.
 - (M) Subrecipient monitoring.
 - (N) Special tests and provisions.
- (xiii) Auditee Name, Employer Identification Number(s), Name and Title of Certifying Official, Telephone Number, Signature, and Date.
- (xiv) Auditor Name, Name and Title of Contact Person, Auditor Address, Auditor Telephone Number, Signature, and Date.
- (xv) Whether the auditee has either a cognizant or oversight agency for audit.
- (xvi) The name of the cognizant or oversight agency for audit determined in accordance with §__.400(a) and §__.400(b), respectively.

- (3) Using the information included in the reporting package described in paragraph (c) of this section, the auditor shall complete the applicable sections of the form. The auditor shall sign a statement to be included as part of the data collection form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package described in paragraph (c) of this section, and that the content of the form is limited to the data elements prescribed by OMB.
- (c) *Reporting package.* The reporting package shall include the:
 - (1) Financial statements and schedule of expenditures of Federal awards discussed in §__310(a) and §__310(b), respectively;
 - (2) Summary schedule of prior audit findings discussed in §__315(b);
 - (3) Auditor's report(s) discussed in §__505; and
 - (4) Corrective action plan discussed in §__315(c).
- (d) *Submission to clearinghouse.* All auditees shall submit to the Federal clearinghouse designated by OMB the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section for:
 - (1) The Federal clearinghouse to retain as an archival copy; and
 - (2) Each Federal awarding agency when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the Federal awarding agency provided directly or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the Federal awarding agency provided directly.
- (e) *Additional submission by subrecipients.* (1) In addition to the requirements discussed in paragraph (d) of this section, auditees that are also subrecipients shall submit to each pass-through entity one copy of the reporting package described in paragraph (c) of this section for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the pass-through entity provided or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the pass-through entity provided.
 - (2) Instead of submitting the reporting package to a pass-through entity, when a subrecipient is not required to submit a reporting package to a pass-through entity pursuant to paragraph (e)(1) of this section, the subrecipient shall provide written notification to the pass-through entity that: an audit of the subrecipient was conducted in accordance with this part (including the period covered by the audit and the name, amount, and CFDA number of the Federal award(s) provided by the pass-through entity); the schedule of findings and questioned costs disclosed no audit findings relating to the Federal award(s) that the pass-through entity provided; and, the summary schedule of prior audit findings did not report on the status of any audit findings relating to the Federal award(s) that the pass-through entity provided. A subrecipient may submit a copy of the reporting package described in paragraph (c) of this section to a pass-through entity to comply with this notification requirement.
- (f) *Requests for report copies.* In response to requests by a Federal agency or pass-through entity, auditees shall submit the appropriate copies of the reporting package described in paragraph (c) of this section and, if requested, a copy of any management letters issued by the auditor.

(g) *Report retention requirements.* Auditees shall keep one copy of the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section on file for three years from the date of submission to the Federal clearinghouse designated by OMB. Pass-through entities shall keep subrecipients' submissions on file for three years from date of receipt.

(h) *Clearinghouse responsibilities.* The Federal clearinghouse designated by OMB shall distribute the reporting packages received in accordance with paragraph (d)(2) of this section and §__.235(c)(3) to applicable Federal awarding agencies, maintain a data base of completed audits, provide appropriate information to Federal agencies, and follow up with known auditees which have not submitted the required data collection forms and reporting packages.

(i) *Clearinghouse address.* The address of the Federal clearinghouse currently designated by OMB is Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th Street, Jeffersonville, IN 47132.

(j) *Electronic filing.* Nothing in this part shall preclude electronic submissions to the Federal clearinghouse in such manner as may be approved by OMB. With OMB approval, the Federal clearinghouse may pilot test methods of electronic submissions.

Subpart D—Federal Agencies and Pass-Through Entities

§__.400 Responsibilities.

(a) *Cognizant agency for audit responsibilities.* Recipients expending more than \$25 million (*\$50 million for fiscal years ending after December 31, 2003*) year in Federal awards shall have a cognizant agency for audit. The designated cognizant agency for audit shall be the Federal awarding agency that provides the predominant amount of direct funding to a recipient unless OMB makes a specific cognizant agency for audit assignment.

Following is effective for fiscal years ending on or before December 31, 2003:

To provide for continuity of cognizance, the determination of the predominant amount of direct funding shall be based upon direct Federal awards expended in the recipient's fiscal years ending in 1995, 2000, 2005, and every fifth year thereafter. For example, audit cognizance for periods ending in 1997 through 2000 will be determined based on Federal awards expended in 1995. (However, for States and local governments that expend more than \$25 million a year in Federal awards and have previously assigned cognizant agencies for audit, the requirements of this paragraph are not effective until fiscal years beginning after June 30, 2000.)

Following is effective for fiscal years ending after December 31, 2003:

The determination of the predominant amount of direct funding shall be based upon direct Federal awards expended in the recipient's fiscal years ending in 2004, 2009, 2014, and every fifth year thereafter. For example, audit cognizance for periods ending in 2006 through 2010 will be determined based on Federal awards expended in 2004. (However, for 2001 through 2005, the cognizant agency for audit is determined based on the predominant amount of direct Federal awards expended in the recipient's fiscal year ending in 2000).

Notwithstanding the manner in which audit cognizance is determined, a Federal awarding agency with cognizance for an auditee may reassign cognizance to another Federal awarding agency which provides substantial direct funding and agrees to be the cognizant agency for audit. Within 30 days after any reassignment, both the old and the new cognizant agency for audit shall notify the auditee, and, if known, the auditor of the reassignment. The cognizant agency for audit shall:

- (1) Provide technical audit advice and liaison to auditees and auditors.
 - (2) Consider auditee requests for extensions to the report submission due date required by §__.320(a). The cognizant agency for audit may grant extensions for good cause.
 - (3) Obtain or conduct quality control reviews of selected audits made by non-Federal auditors, and provide the results, when appropriate, to other interested organizations.
 - (4) Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by GAGAS or laws and regulations.
 - (5) Advise the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee shall work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit shall notify the auditor, the auditee, and applicable Federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance by auditors shall be referred to appropriate State licensing agencies and professional bodies for disciplinary action.
 - (6) Coordinate, to the extent practical, audits or reviews made by or for Federal agencies that are in addition to the audits made pursuant to this part, so that the additional audits or reviews build upon audits performed in accordance with this part.
 - (7) Coordinate a management decision for audit findings that affect the Federal programs of more than one agency.
 - (8) Coordinate the audit work and reporting responsibilities among auditors to achieve the most cost-effective audit.
 - (9) For biennial audits permitted under §__.220, consider auditee requests to qualify as a low-risk auditee under §__.530(a).
- (b) *Oversight agency for audit responsibilities.* An auditee which does not have a designated cognizant agency for audit will be under the general oversight of the Federal agency determined in accordance with §__.105. The oversight agency for audit:
- (1) Shall provide technical advice to auditees and auditors as requested.
 - (2) May assume all or some of the responsibilities normally performed by a cognizant agency for audit.
- (c) *Federal awarding agency responsibilities.* The Federal awarding agency shall perform the following for the Federal awards it makes:
- (1) Identify Federal awards made by informing each recipient of the CFDA title and number, award name and number, award year, and if the award is for R&D. When some of this information is not available, the Federal

agency shall provide information necessary to clearly describe the Federal award.

- (2) Advise recipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements.
- (3) Ensure that audits are completed and reports are received in a timely manner and in accordance with the requirements of this part.
- (4) Provide technical advice and counsel to auditees and auditors as requested.
- (5) Issue a management decision on audit findings within six months after receipt of the audit report and ensure that the recipient takes appropriate and timely corrective action.
- (6) Assign a person responsible for providing annual updates of the compliance supplement to OMB.

(d) *Pass-through entity responsibilities.* A pass-through entity shall perform the following for the Federal awards it makes:

- (1) Identify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year, if the award is R&D, and name of Federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the Federal award.
- (2) Advise subrecipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements imposed by the pass-through entity.
- (3) Monitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- (4) Ensure that subrecipients expending \$300,000 (*\$500,000 for fiscal years ending after December 31, 2003*) or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.
- (5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.
- (6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.
- (7) Require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with this part.

§ .405 Management decision.

(a) *General.* The management decision shall clearly state whether or not the audit finding is sustained, the reasons for the decision, and the expected auditee action to repay disallowed costs, make financial adjustments, or take other action. If the auditee has not completed corrective action, a timetable for follow-up should be given. Prior to issuing the management decision, the Federal agency or pass-through entity may request additional information or documentation from the auditee, including a request for auditor assurance related to the documentation, as a way of mitigating disallowed costs. The management decision should describe any appeal process available to the auditee.

(b) *Federal agency.* As provided in § __.400(a)(7), the cognizant agency for audit shall be responsible for coordinating a management decision for audit findings that affect the programs of more than one Federal agency. As provided in § __.400(c)(5), a Federal awarding agency is responsible for issuing a management decision for findings that relate to Federal awards it makes to recipients. Alternate arrangements may be made on a case-by-case basis by agreement among the Federal agencies concerned.

(c) *Pass-through entity.* As provided in § __.400(d)(5), the pass-through entity shall be responsible for making the management decision for audit findings that relate to Federal awards it makes to subrecipients.

(d) *Time requirements.* The entity responsible for making the management decision shall do so within six months of receipt of the audit report. Corrective action should be initiated within six months after receipt of the audit report and proceed as rapidly as possible.

(e) *Reference numbers.* Management decisions shall include the reference numbers the auditor assigned to each audit finding in accordance with § __.510(c).

Subpart E—Auditors

§ __.500 Scope of audit.

(a) *General.* The audit shall be conducted in accordance with GAGAS. The audit shall cover the entire operations of the auditee; or, at the option of the auditee, such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year, provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and other organizational unit, which shall be considered to be a non-Federal entity. The financial statements and schedule of expenditures of Federal awards shall be for the same fiscal year.

(b) *Financial statements.* The auditor shall determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. The auditor shall also determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.

(c) *Internal control.* (1) In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs.

(2) Except as provided in paragraph (c)(3) of this section, the auditor shall:

- (i) Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and
- (ii) Perform testing of internal control as planned in paragraph (c)(2)(i) of this section.

(3) When internal control over some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the planning and performing of testing described in paragraph (c)(2) of this section are not required for those compliance requirements. However, the auditor shall report a reportable condition

(including whether any such condition is a material weakness) in accordance with §__.510, assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.

(d) *Compliance.* (1) In addition to the requirements of GAGAS, the auditor shall determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs.

(2) The principal compliance requirements applicable to most Federal programs and the compliance requirements of the largest Federal programs are included in the compliance supplement.

(3) For the compliance requirements related to Federal programs contained in the compliance supplement, an audit of these compliance requirements will meet the requirements of this part. Where there have been changes to the compliance requirements and the changes are not reflected in the compliance supplement, the auditor shall determine the current compliance requirements and modify the audit procedures accordingly. For those Federal programs not covered in the compliance supplement, the auditor should use the types of compliance requirements contained in the compliance supplement as guidance for identifying the types of compliance requirements to test, and determine the requirements governing the Federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

(4) The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.

(e) *Audit follow-up.* The auditor shall follow-up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee in accordance with §__.315(b), and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor shall perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year.

(f) *Data Collection Form.* As required in §__.320(b)(3), the auditor shall complete and sign specified sections of the data collection form.

§__.505 Audit reporting.

The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:

(a) An opinion (or disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles and an opinion (or disclaimer of opinion) as to whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.

(b) A report on internal control related to the financial statements and major programs. This report shall describe the scope of testing of internal control and

the results of the tests, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.

(c) A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report shall also include an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on each major program, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.

(d) A schedule of findings and questioned costs which shall include the following three components:

- (1) A summary of the auditor's results which shall include:
 - (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
 - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses;
 - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee;
 - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses;
 - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
 - (vi) A statement as to whether the audit disclosed any audit findings which the auditor is required to report under § __.510(a);
 - (vii) An identification of major programs;
 - (viii) The dollar threshold used to distinguish between Type A and Type B programs, as described in § __.520(b); and
 - (ix) A statement as to whether the auditee qualified as a low-risk auditee under § __.530.
- (2) Findings relating to the financial statements which are required to be reported in accordance with GAGAS.
- (3) Findings and questioned costs for Federal awards which shall include audit findings as defined in § __.510(a).
 - (i) Audit findings (e.g., internal control findings, compliance findings, questioned costs, or fraud) which relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by Federal agency or pass-through entity.
 - (ii) Audit findings which relate to both the financial statements and Federal awards, as reported under paragraphs (d)(2) and (d)(3) of this section, respectively, should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form with a reference to a detailed reporting in the other section of the schedule.

§ 510 Audit findings.

(a) *Audit findings reported.* The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

- (1) Reportable conditions in internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement. The auditor shall identify reportable conditions which are individually or cumulatively material weaknesses.
- (2) Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the compliance supplement.
- (3) Known questioned costs which are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor shall also report known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. In reporting questioned costs, the auditor shall include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.
- (4) Known questioned costs which are greater than \$10,000 for a Federal program which is not audited as a major program. Except for audit follow-up, the auditor is not required under this part to perform audit procedures for such a Federal program; therefore, the auditor will normally not find questioned costs for a program which is not audited as a major program. However, if the auditor does become aware of questioned costs for a Federal program which is not audited as a major program (e.g., as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor shall report this as an audit finding.
- (5) The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for Federal awards.
- (6) Known fraud affecting a Federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for Federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAGAS.
- (7) Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in

accordance with § __.315(b) materially misrepresents the status of any prior audit finding.

(b) *Audit finding detail.* Audit findings shall be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for Federal agencies and pass-through entities to arrive at a management decision. The following specific information shall be included, as applicable, in audit findings:

- (1) Federal program and specific Federal award identification including the CFDA title and number, Federal award number and year, name of Federal agency, and name of the applicable pass-through entity. When information, such as the CFDA title and number or Federal award number, is not available, the auditor shall provide the best information available to describe the Federal award.
- (2) The criteria or specific requirement upon which the audit finding is based, including statutory, regulatory, or other citation.
- (3) The condition found, including facts that support the deficiency identified in the audit finding.
- (4) Identification of questioned costs and how they were computed.
- (5) Information to provide proper perspective for judging the prevalence and consequences of the audit findings, such as whether the audit findings represent an isolated instance or a systemic problem. Where appropriate, instances identified shall be related to the universe and the number of cases examined and be quantified in terms of dollar value.
- (6) The possible asserted effect to provide sufficient information to the auditee and Federal agency, or pass-through entity in the case of a subrecipient, to permit them to determine the cause and effect to facilitate prompt and proper corrective action.
- (7) Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- (8) Views of responsible officials of the auditee when there is disagreement with the audit findings, to the extent practical.

(c) *Reference numbers.* Each audit finding in the schedule of findings and questioned costs shall include a reference number to allow for easy referencing of the audit findings during follow-up.

§ __.515 Audit working papers.

(a) *Retention of working papers.* The auditor shall retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report(s) to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the Federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor shall contact the parties contesting the audit finding for guidance prior to destruction of the working papers and reports.

(b) *Access to working papers.* Audit working papers shall be made available upon request to the cognizant or oversight agency for audit or its designee, a Federal agency providing direct or indirect funding, or GAO at the completion of the audit, as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this part. Access to working papers includes the right of Federal agencies to obtain copies of working papers, as is reasonable and necessary.

§ 520 Major program determination.

(a) *General.* The auditor shall use a risk-based approach to determine which Federal programs are major programs. This risk-based approach shall include consideration of: Current and prior audit experience, oversight by Federal agencies and pass-through entities, and the inherent risk of the Federal program. The process in paragraphs (b) through (i) of this section shall be followed.

(b) *Step 1.* (1) The auditor shall identify the larger Federal programs, which shall be labeled Type A programs. Type A programs are defined as Federal programs with Federal awards expended during the audit period exceeding the larger of:

- (i) \$300,000 or three percent (.03) of total Federal awards expended in the case of an auditee for which total Federal awards expended equal or exceed \$300,000 but are less than or equal to \$100 million.
- (ii) \$3 million or three-tenths of one percent (.003) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$100 million but are less than or equal to \$10 billion.
- (iii) \$30 million or 15 hundredths of one percent (.0015) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$10 billion.

(2) Federal programs not labeled Type A under paragraph (b)(1) of this section shall be labeled Type B programs.

(3) The inclusion of large loan and loan guarantees (loans) should not result in the exclusion of other programs as Type A programs. When a Federal program providing loans significantly affects the number or size of Type A programs, the auditor shall consider this Federal program as a Type A program and exclude its values in determining other Type A programs.

(4) For biennial audits permitted under § 220, the determination of Type A and Type B programs shall be based upon the Federal awards expended during the two-year period.

(c) *Step 2.* (1) The auditor shall identify Type A programs which are low-risk. For a Type A program to be considered low-risk, it shall have been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and, in the most recent audit period, it shall have had no audit findings under § 510(a). However, the auditor may use judgment and consider that audit findings from questioned costs under § 510(a)(3) and § 510(a)(4), fraud under § 510(a)(6), and audit follow-up for the summary schedule of prior audit findings under § 510(a)(7) do not preclude the Type A program from being low-risk. The auditor shall consider: the criteria in § 525(c), § 525(d)(1), § 525(d)(2), and § 525(d)(3); the results of audit follow-up; whether any changes in personnel or systems affecting a Type A program have significantly increased risk; and apply professional judgment in determining whether a Type A program is low-risk.

(2) Notwithstanding paragraph (c)(1) of this section, OMB may approve a Federal awarding agency's request that a Type A program at certain recipients may not be considered low-risk. For example, it may be necessary for a large Type A program to be audited as major each year at particular recipients to allow the Federal agency to comply with the

Government Management Reform Act of 1994 (31 U.S.C. 3515). The Federal agency shall notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year to be audited of OMB's approval.

(d) *Step 3.* (1) The auditor shall identify Type B programs which are high-risk using professional judgment and the criteria in §__.525. However, should the auditor select Option 2 under Step 4 (paragraph (e)(2)(i)(B) of this section), the auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. Except for known reportable conditions in internal control or compliance problems as discussed in '__.525(b)(1), §__.525(b)(2), and §__.525(c)(1), a single criteria in §__.525 would seldom cause a Type B program to be considered high-risk.

(2) The auditor is not expected to perform risk assessments on relatively small Federal programs. Therefore, the auditor is only required to perform risk assessments on Type B programs that exceed the larger of:

- (i) \$100,000 or three-tenths of one percent (.003) of total Federal awards expended when the auditee has less than or equal to \$100 million in total Federal awards expended.
- (ii) \$300,000 or three-hundredths of one percent (.0003) of total Federal awards expended when the auditee has more than \$100 million in total Federal awards expended.

(e) *Step 4.* At a minimum, the auditor shall audit all of the following as major programs:

(1) All Type A programs, except the auditor may exclude any Type A programs identified as low-risk under Step 2 (paragraph (c)(1) of this section).

(2)(i) High-risk Type B programs as identified under either of the following two options:

(A) *Option 1.* At least one half of the Type B programs identified as high-risk under Step 3 (paragraph (d) of this section), except this paragraph (e)(2)(i)(A) does not require the auditor to audit more high-risk Type B programs than the number of low-risk Type A programs identified as low-risk under Step 2.

(B) *Option 2.* One high-risk Type B program for each Type A program identified as low-risk under Step 2.

(ii) When identifying which high-risk Type B programs to audit as major under either Option 1 or 2 in paragraph (e)(2)(i)(A) or (B) of this section, the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.

(3) Such additional programs as may be necessary to comply with the percentage of coverage rule discussed in paragraph (f) of this section. This paragraph (e)(3) may require the auditor to audit more programs as major than the number of Type A programs.

(f) *Percentage of coverage rule.* The auditor shall audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 50 percent of total Federal awards expended. If the auditee meets the criteria in §__.530 for a low-risk auditee, the auditor need only audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 25 percent of total Federal awards expended.

(g) *Documentation of risk.* The auditor shall document in the working papers the risk analysis process used in determining major programs.

(h) *Auditor's judgment.* When the major program determination was performed and documented in accordance with this part, the auditor's judgment in applying the risk-based approach to determine major programs shall be presumed correct. Challenges by Federal agencies and pass-through entities shall only be for clearly improper use of the guidance in this part. However, Federal agencies and pass-through entities may provide auditors guidance about the risk of a particular Federal program and the auditor shall consider this guidance in determining major programs in audits not yet completed.

(i) *Deviation from use of risk criteria.* For first-year audits, the auditor may elect to determine major programs as all Type A programs plus any Type B programs as necessary to meet the percentage of coverage rule discussed in paragraph (f) of this section. Under this option, the auditor would not be required to perform the procedures discussed in paragraphs (c), (d), and (e) of this section.

- (1) A first-year audit is the first year the entity is audited under this part or the first year of a change of auditors.
- (2) To ensure that a frequent change of auditors would not preclude audit of high-risk Type B programs, this election for first-year audits may not be used by an auditee more than once in every three years.

§ 525 Criteria for Federal program risk.

(a) *General.* The auditor's determination should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the Federal program. The auditor shall use auditor judgment and consider criteria, such as described in paragraphs (b), (c), and (d) of this section, to identify risk in Federal programs. Also, as part of the risk analysis, the auditor may wish to discuss a particular Federal program with auditee management and the Federal agency or pass-through entity.

(b) *Current and prior audit experience.* (1) Weaknesses in internal control over Federal programs would indicate higher risk. Consideration should be given to the control environment over Federal programs and such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements and the competence and experience of personnel who administer the Federal programs.

- (i) A Federal program administered under multiple internal control structures may have higher risk. When assessing risk in a large single audit, the auditor shall consider whether weaknesses are isolated in a single operating unit (e.g., one college campus) or pervasive throughout the entity.
 - (ii) When significant parts of a Federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk.
 - (iii) The extent to which computer processing is used to administer Federal programs, as well as the complexity of that processing, should be considered by the auditor in assessing risk. New and recently modified computer systems may also indicate risk.
- (2) Prior audit findings would indicate higher risk, particularly when the situations identified in the audit findings could have a significant impact on a Federal program or have not been corrected.

- (3) Federal programs not recently audited as major programs may be of higher risk than Federal programs recently audited as major programs without audit findings.

(c) *Oversight exercised by Federal agencies and pass-through entities.* (1) Oversight exercised by Federal agencies or pass-through entities could indicate risk. For example, recent monitoring or other reviews performed by an oversight entity which disclosed no significant problems would indicate lower risk. However, monitoring which disclosed significant problems would indicate higher risk.

- (2) Federal agencies, with the concurrence of OMB, may identify Federal programs which are higher risk. OMB plans to provide this identification in the compliance supplement.

(d) *Inherent risk of the Federal program.* (1) The nature of a Federal program may indicate risk. Consideration should be given to the complexity of the program and the extent to which the Federal program contracts for goods and services. For example, Federal programs that disburse funds through third party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high-risk for time and effort reporting, but otherwise be at low-risk.

- (2) The phase of a Federal program in its life cycle at the Federal agency may indicate risk. For example, a new Federal program with new or interim regulations may have higher risk than an established program with time-tested regulations. Also, significant changes in Federal programs, laws, regulations, or the provisions of contracts or grant agreements may increase risk.

- (3) The phase of a Federal program in its life cycle at the auditee may indicate risk. For example, during the first and last years that an auditee participates in a Federal program, the risk may be higher due to start-up or closeout of program activities and staff.

- (4) Type B programs with larger Federal awards expended would be of higher risk than programs with substantially smaller Federal awards expended.

§ __.530 Criteria for a low-risk auditee.

An auditee which meets all of the following conditions for each of the preceding two years (or, in the case of biennial audits, preceding two audit periods) shall qualify as a low-risk auditee and be eligible for reduced audit coverage in accordance with § __.520:

(a) Single audits were performed on an annual basis in accordance with the provisions of this part. A non-Federal entity that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.

(b) The auditor's opinions on the financial statements and the schedule of expenditures of Federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of Federal awards and provide a waiver.

(c) There were no deficiencies in internal control which were identified as material weaknesses under the requirements of GAGAS. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of Federal awards and provide a waiver.

(d) None of the Federal programs had audit findings from any of the following in either of the preceding two years (or, in the case of biennial audits, preceding two audit periods) in which they were classified as Type A programs:

- (1) Internal control deficiencies which were identified as material weaknesses;
- (2) Noncompliance with the provisions of laws, regulations, contracts, or grant agreements which have a material effect on the Type A program;
or
- (3) Known or likely questioned costs that exceed five percent of the total Federal awards expended for a Type A program during the year.

Appendix A to Part—Data Collection Form (Form SF-SAC)

[Insert SF-SAC after finalized]

Appendix B to Part—Circular A-133 Compliance Supplement

Note: Provisional OMB Circular A-133 Compliance Supplement is available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503.

Appendix C

Comparison of Key Provisions of the Risk Assessment Standards to Previous Standards

This appendix discusses the key provisions of each of the audit risk SASs and provides a summary of how each of the SASs differs, if at all, from the previous AICPA generally accepted audit standards.

SAS No. 104, Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
|-----------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none">• SAS No. 104 defines <i>reasonable assurance</i> as a "high level of assurance." | <ul style="list-style-type: none">• SAS No. 104 clarifies the meaning of <i>reasonable assurance</i>. |

SAS No. 105, Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures." | <ul style="list-style-type: none"> • Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risks of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • SAS No. 105 emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities. • The term <i>further audit procedures</i>, which consists of test of controls and substantive tests, replaces the term <i>tests to be performed</i> in recognition that risk assessment procedures are also performed. • The term <i>audit evidence</i> replaces the term <i>evidential matter</i>. |

SAS No. 106, Audit Evidence

| Key Provisions | How the SAS Differs From Previous Standards |
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| <ul style="list-style-type: none"> SAS No. 106 defines <i>audit evidence</i> as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based." | <ul style="list-style-type: none"> Previous guidance did not define audit evidence. SAS No. 106 also describes basic concepts of audit evidence. The term <i>sufficient, appropriate audit evidence</i>, defined in SAS No. 106, replaces the term <i>sufficient, competent evidential matter</i>. |
| <ul style="list-style-type: none"> SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures. | <ul style="list-style-type: none"> SAS No. 106 recategorizes assertions to add clarity. <i>Assertion relating to presentation and disclosure</i> has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability). |
| <ul style="list-style-type: none"> SAS No. 106 defines <i>relevant assertions</i> as those assertions that have a meaningful bearing on whether the account is fairly stated. | <ul style="list-style-type: none"> The term <i>relevant assertions</i> is new, and it is used repeatedly throughout SAS No. 106. |
| <ul style="list-style-type: none"> SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence. | <ul style="list-style-type: none"> The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance. |
| <ul style="list-style-type: none"> SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels. | <ul style="list-style-type: none"> SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risks of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditor's opinion on the financial statements. |

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion. | |
| <ul style="list-style-type: none"> • SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor. | <ul style="list-style-type: none"> • Risk assessment procedures include: <ul style="list-style-type: none"> — Inquiries of management and others within the entity — Analytical procedures — Observation and inspection |
| <ul style="list-style-type: none"> • SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure. | <ul style="list-style-type: none"> • Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented. |

SAS No. 107, Audit Risk and Materiality in Conducting an Audit

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: <ol style="list-style-type: none"> 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles. | <ul style="list-style-type: none"> • Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SAS No. 107 states that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement. |
| <ul style="list-style-type: none"> • Combined assessment of inherent and control risks is termed the <i>risk of material misstatement</i>. | <ul style="list-style-type: none"> • SAS No. 107 consistently uses the term <i>risk of material misstatement</i>, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks. |
| <ul style="list-style-type: none"> • The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. • Assessed risks and the basis for those assessments should be documented. | <ul style="list-style-type: none"> • SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum" without having a basis for that assessment. In other words, it is no longer acceptable to "default" to maximum control risk. |

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. | <ul style="list-style-type: none"> • SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but SAS No. 107 provides additional specific guidance on how to determine this threshold. |
| <ul style="list-style-type: none"> • The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit. | <ul style="list-style-type: none"> • SAS No. 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor. |

SAS No. 108, *Planning and Supervision*

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <p>SAS No. 108 provides guidance on:</p> <ul style="list-style-type: none"> • Appointment of the independent auditor. • Establishing an understanding with the auditee. • Preliminary engagement activities. • The overall audit strategy. • The audit plan. • Determining the extent of involvement of professionals possessing specialized skills. • Using a professional possessing IT skills to understand the effect of IT on the audit. • Additional considerations in initial audit engagements. • Supervision of assistants. | <ul style="list-style-type: none"> • Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. <ul style="list-style-type: none"> — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. — The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should establish a written understanding with your auditee regarding the services to be performed for each engagement. |

SAS No. 109, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control. | <ul style="list-style-type: none"> • The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the auditee. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of auditee acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry. |
| <ul style="list-style-type: none"> • The audit team should discuss the susceptibility of the entity's financial statements to material misstatement. | <ul style="list-style-type: none"> • Previous standards did not require a "brainstorming" session to discuss the risks of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar to (and may be performed together with) the brainstorming session to discuss fraud. |
| <ul style="list-style-type: none"> • The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risks of material misstatement" and design and perform further audit procedures responsive to the assessed risks. | <ul style="list-style-type: none"> • SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk. |

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| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • SAS No. 109 states the auditor should assess the risks of material misstatement at both the financial statement and relevant assertion levels. | <ul style="list-style-type: none"> • The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level. |
| <ul style="list-style-type: none"> • SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented. | <ul style="list-style-type: none"> • Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditor's opinion on the financial statements. • The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they have been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control. |
| <ul style="list-style-type: none"> • SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. | <ul style="list-style-type: none"> • Previous standard did not include the concept of "significant risks." • Significant risks exist on most engagements. • The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks. |

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • SAS No. 109 provides extensive guidance on the matters that should be documented. | <ul style="list-style-type: none"> • The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards. |

SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • SAS No. 110 provides guidance on determining overall responses to address the risks of material misstatement at the financial statement level and the nature of those responses. | <ul style="list-style-type: none"> • The concept of addressing the risks of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affects individual financial statement assertions, so you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risks of material misstatement at the financial statement level also has been expanded. |
| <ul style="list-style-type: none"> • Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risks of material misstatement at the relevant assertion level. | <ul style="list-style-type: none"> • Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards. |

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures. | <ul style="list-style-type: none"> • The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risks of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: <ul style="list-style-type: none"> — Performing substantive tests for all relevant assertions related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risks of material misstatements. — Agreeing the financial statements, including their accompanying notes, to the underlying accounting records — Examining material journal entries and other adjustments made during the course of preparing the financial statements |

SAS No. 111, Amendment to Statement on Auditing Standards No. 39, Audit Sampling

| <i>Key Provisions</i> | <i>How the SAS Differs From Previous Standards</i> |
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| <ul style="list-style-type: none"> • SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls. | <ul style="list-style-type: none"> • SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment. • Ordinarily sample sizes for non-statistical samples are comparable to sample sizes for an efficient and effectively designed statistical sample with the same sampling parameters. |

Appendix D

Schedule of Changes Made to the Text From the Previous Edition

As of August 1, 2008

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

Terms Used to Define Professional Requirements

The 2008 editions of the AICPA Audit and Accounting Guides, including this guide, have been updated to conform with AU section 120, *Defining Professional Requirements in Statements on Auditing Standards*, AT section 20, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1), and AR section 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2), in which professional requirements are categorized as either *unconditional requirements* or *presumptively mandatory requirements*, each of which is associated with specific wording such as "must" or "is required" or "should." These standards distinguish *professional requirements* set forth in the standards from *explanatory material* contained in the standards, the latter of which requires only the auditor's, practitioner's, or accountant's "attention and understanding." Whether the auditor, practitioner, or accountant performs the suggested procedures or actions in the engagement (as stated in the explanatory material) depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard.

Because interpretive publications (including AICPA Audit and Accounting Guides, for example) are recommendations, the publications cannot establish requirements. Paragraph .06 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), states, "The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance."

An interpretive publication, such as this guide, should state the requirement of the standard, and then give recommendations on the application of the requirement in the specific circumstances. The terms *must*, *is required*, or *should* may be used in an interpretive publication only when it is clear that the requirement originated in a standard. Otherwise, the user may be uncertain whether a requirement or a recommendation is intended. The following conventions were

used to conform the AICPA Audit and Accounting Guides to these standards, which define professional requirements:

- Terms to replace the use of *must*, *should*, and *is required* consist only of those explanatory material terms included in AU section 120, AT section 20, and AR section 20: *could*, *may*, and *might*, and these variations of those terms: *could consider*, *may consider*, and *might consider*.
- When referring guide users to interpretive publications (which consist of interpretations of the Statements on Auditing Standards [SASs], appendixes to the SASs, auditing guidance in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position) or to nonauthoritative knowledge sources, if an auditor can perform an adequate risk assessment without the recommended knowledge, *explanatory material* terms are used; if not, *should* or *should consider* is used.
- Specific auditing procedures generally are explanatory in nature (the standards generally do not include specific audit procedures). As such, explanatory material terms (*could*, *may*, *might*, *could consider*, *may consider*, or *might consider*) are used, unless the specific audit procedure is the established way or only way of achieving a generally accepted auditing standard objective for this industry, in which case *should* is used.
- If the recommendation is that the auditor consult or familiarize himself or herself with other sources of information, such as Securities and Exchange Commission (SEC) regulations, income tax laws, and industry developments including regulatory, economic, and legislative developments, then the following considerations were used in developing which terms to use in the guides:
 - If the purpose of the recommendation is for the auditor, practitioner, or accountant to develop the required understanding of the entity and its environment for risk assessment purposes, and an auditor can perform an adequate risk assessment without the recommended knowledge, *explanatory material* terms are used within the recommendation; if not, *should* or *must* is used depending upon the associated standard requirement.
 - If the purpose of the recommendation is for the auditor, practitioner, or accountant to perform the engagement in accordance with AICPA *Professional Standards*, and the knowledge is available *only* from the source cited (such as SEC regulations, income tax law, and the like), then *should* is used. If the knowledge is available from other sources as well, *explanatory material* terms are used.
- The guides contain guidance for management which includes best practices for the industry. Because the recommendations are best practices, the terms *ordinarily should* or *generally should* are used.

| <u>Reference</u> | <u>Change</u> |
|---------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Notice to Readers and Preface | Updated. |
| Note to chapter 1 | Revised to reflect issuance and effective date of the 2007 revision of <i>Government Auditing Standards</i> (subsequently these changes will be referred to as "2007 revision of <i>Government Auditing Standards</i> "). |
| Paragraph 1.01 | Revised for passage of time; footnote 1 (former footnote 2) revised for 2007 revision of <i>Government Auditing Standards</i> ; former footnotes 1 and 3–4 deleted. |
| Footnote * in paragraph 1.01 | Deleted. |
| Paragraph 1.02 | Added to incorporate relevant information in former footnote 1. |
| Paragraph 1.03 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for clarification. |
| Paragraph 1.04 | Added to reflect relevant information in former footnote 4. |
| Paragraph 1.05 | Revised for clarification. |
| Paragraph 1.06 | Added to reflect relevant information in former footnote 3. |
| Paragraph 1.08 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 1.11 | Revised for clarification. |
| Paragraph 1.13 | Revised to reflect the issuance of SAS No. 106. |
| Note to chapter 2 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.01 and footnote 1 (former footnote 2) | Revised for clarification, former footnotes 1 and 3 deleted. |
| Footnote * in paragraph 2.01 | Deleted. |
| Paragraphs 2.02–2.05 | Added for 2007 revision of <i>Government Auditing Standards</i> ; footnote 2 in paragraph 2.05 revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.06 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for effective date of AU section 150; footnote 5 revised for clarification. |
| Paragraph 2.07 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 6 added to reflect the issuance of guidance related to PCAOB standards available on the GAO Web site. |

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| <u>Reference</u> | <u>Change</u> |
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| Paragraph 2.08 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 7 added for clarification. |
| Paragraph 2.09 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.10 and footnote 8 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.11 and footnote 9 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 10 added for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.12 | Added for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.13 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 11 added for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.14 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 12 added for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.15, footnote 14 in paragraph 2.15, paragraph 2.16 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Footnote † in paragraph 2.16 | Deleted. |
| Paragraphs 2.17–.18, footnote 15 in paragraph 2.18, paragraph 2.19 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.20 | Revised for clarification. |
| Paragraph 2.21 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.22 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; former footnote 16 deleted due to 2007 revision to <i>Government Auditing Standards</i> ; footnote 17 added for clarification; footnote 18 revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.23 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 19 added for 2007 revision of <i>Government Auditing Standards</i> . |
| Former footnote 15 in paragraph 2.24 | Deleted for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 2.24–.31 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |

| <u>Reference</u> | <u>Change</u> |
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| Former paragraph 2.31 and former footnotes 19–20 | Deleted for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 2.32–.34 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.35 | Revised to reflect the appropriate use of terms used to define the professional requirements of auditors, practitioners, and accountants in AU section 120, AT section 20, and AR section 20 of AICPA <i>Professional Standards</i> . Subsequently, these changes are referred to as <i>defining professional requirements</i> in the Schedule of Changes. |
| Paragraphs 2.36–.39 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 2.40 | Revised to reflect the issuance of SAS No. 114. |
| Paragraph 2.41 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 22 added for 2007 revision of <i>Government Auditing Standards</i> ; footnote 23 revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Footnote ‡ in paragraph 2.42 | Deleted. |
| Paragraphs 2.43–.44 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 2.45 and 2.47–.48 | Revised to define professional requirements. |
| Paragraph 2.49 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised to define professional requirements. |
| Paragraph 2.50 | Revised to define professional requirements. |
| Note to chapter 3 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Footnotes * and † in paragraph 3.01 | Deleted. |
| Footnote 2 in paragraph 3.02 | Added for clarification of the incorporation of the risk assessment standards in this edition. |
| Paragraph 3.03 | Revised for conforming changes related to the risk assessment standards. Subsequently, these changes are referred to as "risk assessment standards" in the schedule of changes. |
| Footnote ‡ in paragraph 3.03 | Deleted. |

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| <u>Reference</u> | <u>Change</u> |
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| Paragraphs 3.04–.09 | Revised for risk assessment standards. |
| Paragraph 3.10 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised to define professional requirements; footnote 5 added to reflect issuance of guidance related to PCAOB standards available on the GAO Web site. |
| Footnotes and # in paragraph 3.10 | Deleted. |
| Paragraph 3.11 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 3.12 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for clarification. |
| Paragraph 3.13 | Revised to define professional requirements. |
| Paragraph 3.14 | Revised for clarification. |
| Paragraph 3.15 | Revised to define professional requirements. |
| Footnote ** in paragraph 3.15 | Deleted. |
| Paragraph 3.16 | Revised to define professional requirements. |
| Paragraphs 3.19–.21 and 3.24 | Revised for clarification. |
| Paragraph 3.26 | Revised to define professional requirements. |
| Paragraph 3.27 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 3.28–.29 | Revised to define professional requirements. |
| Paragraphs 3.30–.31 | Revised for clarification; revised to define professional requirements. |
| Paragraph 3.32 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for clarification; footnote 11 added for clarification. |
| Paragraph 3.33 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; deleted former footnote 11 for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 3.34 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for clarification; former footnote 12 deleted for 2007 revision of <i>Government Auditing Standards</i> . |
| Notes to exhibit 3-1 | Revised to define professional requirements. |
| Former paragraph 3.35 | Deleted for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 3.35 | Revised for clarification. |

| <u>Reference</u> | <u>Change</u> |
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| Paragraph 3.36 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 3.37 | Revised to define professional requirements; revised for clarification; revised for 2007 revision of <i>Government Auditing Standards</i> ; former footnote 17 deleted for 2007 revision of <i>Government Auditing Standards</i> . |
| Footnote †† in paragraph 3.37 | Deleted. |
| Paragraph 3.38 | Revised for risk assessment standards. |
| Footnote †† in paragraph 3.38 | Deleted. |
| Note to chapter 4 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.01 | Revised for clarification. |
| Footnote * in paragraph 4.01 | Deleted. |
| Paragraphs 4.02–.03 | Revised to define professional requirements; revised for clarification. |
| Paragraph 4.04 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.05 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for clarification; footnote 8 revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.06 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.07 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for clarification. |
| Paragraph 4.08 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for risk assessment standards. |
| Footnotes † and ‡ in paragraph 4.08 | Deleted. |
| Paragraph 4.09 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 12 added for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.11 | Revised to define professional requirements. |
| Paragraphs 4.14–.15 | Revised for clarification. |
| Paragraphs 4.16–.17 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |

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| <u>Reference</u> | <u>Change</u> |
|----------------------------------------------|------------------------------------------------------------------------------------------------------------------------------|
| Paragraph 4.18 | Added for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.19 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Former paragraph 4.20 | Deleted for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 4.20–.21 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.22 | Revised to define professional requirements; footnote 20 revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.24 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.25 | Added for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.26 | Revised for clarification. |
| Footnote 28 in paragraph 4.28 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Footnote 31 in heading before paragraph 4.29 | Added for clarification. |
| Paragraph 4.29 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 4.30–.31 | Revised to define professional requirements. |
| Paragraphs 4.32–.33 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.34 | Revised for clarification. |
| Paragraphs 4.35–.37 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Footnote 37 in paragraph 4.37 | Added for clarification. |
| Paragraph 4.38 | Revised for clarification. |
| Paragraphs 4.42 and 4.45 | Revised to define professional requirements. |
| Footnote 41 in paragraph 4.46 | Added for clarification. |
| Paragraph 4.47 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Former paragraphs 4.47–.48 | Deleted for passage of time. |

| <u>Reference</u> | <u>Change</u> |
|---------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Paragraph 4.48 | Revised to define professional requirements. |
| Paragraph 4.49 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 4.50 | Revised to define professional requirements. |
| Paragraph 4.51, appendix A, former sections A-2–A-5 including related footnotes | Deleted due to passage of time. |
| Footnote 29 in paragraph 4.51 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Note to chapter 5 and paragraph 5.02 | Revised for clarification. |
| Paragraph 5.03 | Revised to define professional requirements. |
| Former footnote * in paragraph 5.04 | Converted to permanent footnote 6. |
| Paragraph 5.06 | Revised to define professional requirements. |
| Paragraph 5.07 | Revised to define professional requirements. |
| Paragraph 5.12 | Revised for guidance at http://CFDA.gov . |
| Paragraph 5.17 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised to define professional requirements; footnote 7 revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 5.18 | Revised to define professional requirements. |
| Paragraph 5.20 | Revised for clarification; revised to define professional requirements; footnote 8 revised for clarification. |
| Paragraphs 5.22, 5.27–.28, and 5.32–.33 | Revised to define professional requirements. |
| Paragraphs 5.34–.35 | Revised for clarification. |
| Paragraph 5.37 | Revised to define professional requirements; footnote * added. |
| Paragraphs 5.39 and 5.42–.43 | Revised to define professional requirements. |
| Paragraph 5.44 | Revised for clarification. |
| Paragraph 5.46 | Revised to define professional requirements. |
| Footnote 11 in paragraph 5.47, note to chapter 6, and paragraph 6.02 | Revised for clarification. |

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| <u>Reference</u> | <u>Change</u> |
|-------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------|
| Paragraph 6.04 | Revised for 2007 revision of <i>Government Auditing Standards</i> ; revised for risk assessment standards; revised to define professional requirements. |
| Paragraph 6.05 | Added for risk assessment standards. |
| Paragraph 6.06 | Revised for clarification; revised to define professional requirements. |
| Footnote * in paragraph 6.06 | Deleted. |
| Paragraph 6.07 | Revised to define professional requirements; revised for clarification. |
| Paragraphs 6.08–.09 | Revised to define professional requirements. |
| Paragraph 6.10 | Revised for clarification; revised to define professional requirements. |
| Paragraph 6.11 | Revised to define professional requirements. |
| Paragraph 6.12 | Revised to define professional requirements; footnote 4 added for clarification. |
| Paragraphs 6.14–.18 | Revised to define professional requirements. |
| Paragraph 6.19 | Added for risk assessment standards. |
| Paragraph 6.21 | Revised to define professional requirements; revised for clarification. |
| Paragraphs 6.22–.28 | Added for discussion of audit risk moved from former chapter 8; revised for clarification. |
| Paragraphs 6.30–.31 | Revised to define professional requirements. |
| Paragraph 6.32 | Revised for clarification; footnote 7 revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 6.33 | Revised for clarification. |
| Paragraph 6.34 | Revised to define professional requirements; revised for clarification. |
| Paragraph 6.36 | Revised to define professional requirements. |
| Heading before paragraph 6.38 | Revised for clarification. |
| Paragraph 6.40 | Revised to define professional requirements; revised for clarification. |
| Footnote 9 in paragraph 6.44 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Note to chapter 7 | Revised for clarification. |
| Paragraphs 7.01–.03 | Revised to define professional requirements; revised for clarification. |
| Former paragraph 7.04 | Deleted. |

| <u>Reference</u> | <u>Change</u> |
|-----------------------------------------------|------------------------------------------------------------------------------------------------------------------|
| Paragraphs 7.04–.08 | Added for clarification. |
| Paragraph 7.09 | Revised to define professional requirements; revised for clarification. |
| Paragraph 7.10 | Revised to define professional requirements. |
| Heading before paragraph 7.12, paragraph 7.12 | Revised for clarification. |
| Heading before paragraph 7.14, paragraph 7.14 | Added for clarification. |
| Paragraphs 7.16 and 7.18 | Revised to define professional requirements. |
| Paragraph 7.20 | Revised to define professional requirements; revised for clarification. |
| Paragraph 7.21 | Added for guidance in AU section 339. |
| Footnotes 4, 6, and 11–12 in paragraph 7.22 | Revised to define professional requirements. |
| Note to chapter 8 | Revised for clarification. |
| Paragraphs 8.01 and 8.03 | Revised to define professional requirements. |
| Paragraph 8.04 | Revised for clarification; revised to define professional requirements. |
| Paragraph 8.07 | Revised for clarification. |
| Paragraphs 8.09 and 8.11 | Revised to define professional requirements. |
| Paragraph 8.12 | Revised for passage of time. |
| Paragraphs 8.15, 8.17–.18, and 8.20 | Revised to define professional requirements. |
| Paragraph 8.21 | Revised to define professional requirements; revised for clarification. |
| Paragraphs 8.22–.23 | Revised to define professional requirements. |
| Paragraph 8.26 | Revised for clarification. |
| Paragraphs 8.28 and 8.30 | Revised to define professional requirements. |
| Paragraphs 8.31–.32 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 8.34 | Revised to define professional requirements. |

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| <u>Reference</u> | <u>Change</u> |
|-----------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|
| Paragraph 8.36 | Revised for risk assessment standards; revised to define professional requirements. |
| Note to chapter 9 | Revised for clarification. |
| Paragraph 9.02 | Revised to define professional requirements. |
| Paragraph 9.03 | Revised to define professional requirements; revised for clarification; footnote 1 added for risk assessment standards. |
| Paragraph 9.04 | Revised to define professional requirements. |
| Heading before paragraph 9.06 | Revised for clarification. |
| Former footnote † in paragraph 9.06 | Deleted. |
| Paragraph 9.06 | Revised for risk assessment standards. |
| Paragraph 9.07 | Added for risk assessment standards. |
| Paragraph 9.08 | Revised for risk assessment standards. |
| Former paragraph 10.10 | Deleted for risk assessment standards. |
| Paragraph 9.10 | Revised for clarification. |
| Headings before paragraph 9.11 | Revised for clarification. |
| Paragraph 9.11 | Revised to define professional requirements; revised for risk assessment standards. |
| Paragraphs 9.12–.15 | Added for risk assessment standards. |
| Paragraph 9.16 | Revised for clarification. |
| Former paragraph 10.17 | Deleted for risk assessment standards. |
| Paragraph 9.17 | Revised for clarification; revised to define professional requirements. |
| Paragraph 9.19, heading before paragraph 9.20 | Revised for clarification. |
| Paragraphs 9.20–.21 | Revised for risk assessment standards. |
| Heading before paragraph 9.22 | Revised for clarification. |
| Paragraph 9.22 | Revised to define professional requirements. |
| Paragraph 9.23 | Revised for risk assessment standards. |
| Paragraphs 9.24–.25 | Added for risk assessment standards. |
| Paragraph 9.26 | Revised to define professional requirements; revised for risk assessment standards. |

| <u>Reference</u> | <u>Change</u> |
|---------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Paragraphs 9.27–.28 | Revised to define professional requirements; revised for clarification. |
| Paragraph 9.29 | Added for risk assessment standards. |
| Paragraph 9.30 | Revised to define professional requirements; revised for risk assessment standards. |
| Paragraphs 9.31–.32 and 9.34 | Added for risk assessment standards. |
| Paragraph 9.35 | Revised to define professional requirements; revised for clarification. |
| Paragraph 9.36 | Added for risk assessment standards. |
| Former footnotes † and in paragraph 9.37 | Deleted. |
| Footnotes 3–4 in paragraph 9.37 | Added for guidance in AU section 325A. |
| Paragraph 9.38 | Revised to define professional requirements. |
| Paragraphs 9.39–.47 | Added for guidance in AU section 325A. |
| Paragraph 9.48 | Revised for clarification. |
| Paragraph 9.49 | Revised to define professional requirements; revised for risk assessment standards. |
| Paragraph 9.50 | Added for risk assessment standards. |
| Paragraph 9.51 | Revised for guidance in AU section 339; revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 9.53 | Revised for clarification; former footnote 3 deleted due to 2007 revision of <i>Government Auditing Standards</i> ; footnote 5 revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Note to chapter 10 | Revised for clarification. |
| Paragraph 10.02 | Revised to define professional requirements; revised for clarification. |
| Paragraph 10.03 | Revised to define professional requirements. |
| Paragraph 10.05 | Revised for clarification. |
| Paragraph 10.06 | Revised for clarification; revised for risk assessment standards. |
| Former footnote * in paragraph 10.06 | Deleted. |
| Paragraph 10.07 | Revised for clarification. |
| Former paragraphs 8.07–.12 | Deleted. |
| Paragraph 10.09 | Revised to define professional requirements. |

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| <u>Reference</u> | <u>Change</u> |
|----------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------|
| Paragraph 10.12 | Revised for clarification. |
| Paragraph 10.13 | Revised to define professional requirements. |
| Paragraphs 10.14–.16 | Revised for clarification. |
| Paragraphs 10.18–.19 | Revised to define professional requirements. |
| Paragraphs 10.20–.21 | Revised to define professional requirements; revised for clarification. |
| Paragraphs 10.22 and 10.24–.25 | Revised for clarification. |
| Paragraphs 10.26–.28 | Revised to define professional requirements. |
| Paragraph 10.29 | Revised to define professional requirements; revised for clarification. |
| Paragraphs 10.30–.31 | Added for clarification. |
| Paragraph 10.32 | Revised to define professional requirements. |
| Paragraphs 10.33–.34 | Revised for clarification; revised to define professional requirements. |
| Paragraphs 10.35, 10.37, and 10.40–.41 | Revised for clarification. |
| Paragraph 10.42 | Revised to define professional requirements. |
| Paragraph 10.44 | Revised to define professional requirements; revised for clarification. |
| Paragraph 10.45 | Revised for clarification; former footnote 4 deleted for 2007 revision of <i>Government Auditing Standards</i> ; footnote 4 added for clarification. |
| Paragraph 10.46 | Revised for clarification. |
| Paragraphs 10.47 and 10.49 | Revised to define professional requirements. |
| Paragraphs 10.50–.51 | Revised to define professional requirements; revised for clarification. |
| Paragraph 10.53 | Revised for clarification. |
| Paragraph 10.56 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 7 revised for clarification. |
| Paragraph 10.58 | Revised for clarification; revised to define professional requirements. |
| Paragraphs 10.59 and 10.61–.62 | Revised to define professional requirements. |
| Paragraph 10.63 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> . |

| <u>Reference</u> | <u>Change</u> |
|-------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Paragraph 10.64 | Revised to define professional requirements; revised for clarification. |
| Paragraphs 10.65 and 10.69 | Revised to define professional requirements. |
| Note to chapter 11 | Revised for clarification. |
| Paragraph 11.03 | Revised to define professional requirements. |
| Paragraph 11.06 | Revised to define professional requirements; revised for clarification. |
| Paragraph 11.08 | Revised for clarification. |
| Paragraph 11.16 | Revised to define professional requirements; revised for clarification. |
| Paragraph 11.17 | Revised for clarification. |
| Paragraphs 11.19 and 11.21 | Revised to define professional requirements. |
| Paragraph 11.22 | Revised to define professional requirements; revised for clarification. |
| Paragraphs 11.23–24 | Revised to define professional requirements. |
| Paragraphs 11.29–30 | Revised to define professional requirements. |
| Paragraph 11.31 | Revised for clarification; revised to define professional requirements. |
| Paragraph 11.34 | Revised to define professional requirements. |
| Footnote 3 in paragraph 11.37 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 11.42–.43, 11.45, and 11.47 | Revised to define professional requirements. |
| Note to chapter 12 | Revised for clarification. |
| Paragraphs 12.03–.05 | Revised to define professional requirements. |
| Paragraphs 12.08 and 12.10 | Revised to define professional requirements; revised for clarification. |
| Paragraph 12.16 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> ; former footnote 13 deleted for the 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 12.17 | Revised to define professional requirements. |
| Heading before paragraph 12.18 and paragraphs 12.18–.20 and 12.24 | Revised for clarification. |

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| <u>Reference</u> | <u>Change</u> |
|---------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Paragraph 12.25 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 12.27–.29, 12.31–.32, and footnote 19 in paragraph 12.32 | Revised to define professional requirements. |
| Footnote 22 in heading before paragraph 12.33 | Added for clarification. |
| Paragraph 12.33 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Footnote 23 in heading before paragraph 12.35 | Added for clarification. |
| Paragraph 12.35 | Revised to define professional requirements. |
| Paragraph 12.36 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> ; former footnote 23 deleted for the 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraph 12.37 | Revised to define professional requirements. |
| Paragraph 12.38 | Revised to define professional requirements; revised for 2007 revision of <i>Government Auditing Standards</i> ; footnote 25 revised to define professional requirements. |
| Paragraph 12.41, footnote 26 in paragraph 12.41, paragraph 12.42 | Revised to define professional requirements. |
| Footnote † in heading before paragraph 12.44 | Revised. |
| Paragraphs 12.44–.45 and 12.47 | Revised to define professional requirements. |
| Footnote ‡ in heading before paragraph 12.48 | Revised. |
| Paragraphs 12.48–.49 and 12.51 | Revised to define professional requirements. |
| Paragraph 12.53 and note to chapter 13 | Revised for clarification. |
| Paragraphs 13.03 and 13.06–.07 | Revised to define professional requirements. |

| <u>Reference</u> | <u>Change</u> |
|-----------------------------------------------------------------------|-------------------------------------------------------------------------|
| Paragraph 13.08 | Revised to define professional requirements; revised for clarification. |
| Paragraph 13.09 | Revised for 2007 revision of <i>Government Auditing Standards</i> . |
| Paragraphs 13.10, 13.12-.13, 13.15, and footnote 4 in paragraph 13.16 | Revised to define professional requirements. |

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